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A New Export Policy: The Foreign Sales Corporation and State Unitary Taxation of Foreign Source Income

Reed D. Rubinstein*

The economic health of the United States (U.S.) could be improved through the implementation of a new export policy. To be effective, such a policy should simultaneously encourage the continued expansion of the export production sector of the economy1 and discourage direct foreign investment by U.S. corporations.2 Reductions in the size of the difference between pre-tax and after-tax return on export activity represent an attractive vehicle for implementing the new policy because such reductions will spur corporate investment and production in export industries without necessitating undesirable federal intervention in the basic production and marketing processes.3 Two tax programs are especially

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1. The period since 1970 has been one of massive growth for the export sector of the economy. In 1972, goods manufactured for export constituted 4.8 percent of the total value of U.S. manufactures and 770,000 workers were directly employed in the production of export goods. By 1980, exports constituted 8.3 percent of the total value of U.S. manufactures and 1.5 million workers were employed in export production. BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 780 (1982-83) [hereinafter cited as STATISTICAL ABSTRACT]. These figures become even more impressive in light of the fact that the general unemployment rate for the same period increased nearly 40 percent, moving from 4.7 percent to 7.1 percent. Id. at 375.

Given the present state of the economy, such export production growth is sorely needed. According to the Commerce Department, in the second quarter of 1983, manufacturers were operating at only 73.3 percent of their productive capacity, which constitutes roughly 78 percent of optimum utilization. BUREAU OF ECONOMIC AFFAIRS, U.S. DEP'T OF COMMERCE, 63 SURVEY OF CURRENT BUSINESS 21 table 3 (Sept. 1983). Meanwhile, unemployment for all adults age 16 and older stood at 8.2 percent. BUREAU OF LABOR STATISTICS, U.S. DEP’T OF LABOR, EMPLOYMENT AND EARNINGS 6 at A-1 (Dec. 1983). The evidence indicates that the export production sector of the economy could help significantly in improving those figures.

2. Direct foreign investment by U.S. corporations has increased from $145,990 million in 1977 to $227,343 million in 1982. BUREAU OF ECONOMIC AFFAIRS, U.S. DEP’T OF COMMERCE, 63 SURVEY OF CURRENT BUSINESS 22 table 10 (Aug. 1983). Although it is difficult to estimate the number of jobs or the amount of tax revenue that would have been produced if business had invested those dollars in the domestic economy, there can be no doubt that the figures would be substantial.

3. Arthur B. Laffer, an economist at the University of Southern California, states that “[t]he decision whether or not to work or invest depends upon aftertax income.” Thus, changes in the tax code that affect rates of return on specific investments will necessarily change the behavior of business decision-makers. See How Tax Policy Dampens Economic Growth, Bus. Wk., Apr. 24, 1978, at 61.
well-suited to promote the goals of the new export policy. The proposed Foreign Sales Corporation (FSC)\(^4\) would be an effective export incentive and the unitary system of taxation offers great promise as a practical disincentive to direct foreign investment.

Part I of this note will examine the structure of the FSC, and analyze its potential benefits in light of the Domestic International Sales Corporation (DISC)\(^5\) tax incentive. Part II discusses the use of the unitary tax as a disincentive to direct foreign investment by U.S. corporations. Finally, Part III outlines the new export policy based upon a combination of the FSC export incentive and state unitary taxation of foreign-source income. If implemented, this policy would increase export production and discourage direct foreign investment, thereby making a substantial contribution to U.S. economic well-being.

I. THE FOREIGN SALES CORPORATION

The Foreign Sales Corporation (FSC) is a proposal to use tax incentives to improve the competitive position of American goods in foreign markets\(^6\) and to encourage business investment in the U.S. economy while meeting U.S. obligations under the General Agreement on Tariffs and Trade. The FSC is a descendent of the current federal export tax incentive, the Domestic International Sales Corporation (DISC).\(^7\) Like the DISC, the FSC seeks to enhance the profitability of export production by reducing taxes on profits earned through exporting.\(^8\)

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6. It is generally understood that other Western nations subsidize their exports more than the U.S. does. According to one study, "When actual foreign practices are drawn into the light, it is evident that every country, in one fashion or another, encourages exports by means of the structure and application of its tax laws ... to a greater degree than the U.S." Tax Incentives and Small Business Exports: Hearing before the Subcomm. on Tax, Access to Equity Capital and Business Opportunities of the House Comm. on Small Business, 97th Cong., 2d Sess. 278 (1982) (report on "Foreign Tax Practices Affecting Exports," submitted by Charles M. Bruce, Attorney, Cole & Colette) [hereinafter cited as Hearings, Tax Incentives].
7. See supra note 5.
8. The DISC operated on the basis of special rules that allowed exporters to protect far more income than would be allowed by the traditional tax regulations. Those intercompany pricing rules permit a DISC to realize taxable income in an amount which does not exceed the greater of:
   
   (a) Four percent of the qualified export receipts attributable to the sale of export property plus ten percent of related export promotion expenses, which are defined as the ordinary and necessary expenses incurred to obtain qualified export receipts;
   
   (b) 50 percent of the combined taxable income of the DISC and its related suppliers attributable to qualified export receipts plus ten percent of related export promotion expenses ... [and only the marginal or variable production and sales costs for the export property need be included in the computation of taxable income]; or
   
   (c) taxable income based upon the price actually charged the DISC by its related suppliers if that price is justifiable under the [I.R.C.] section 482 transfer pricing regulations.

Dep't of the Treasury, The Operation and Effect of the Domestic International Sales Corporation Legislation, 1981 Annual Report 5 (1983) [hereinafter cited as Operation and Effect]. The FSC adopts the theoretical approach of the DISC, but is structured somewhat differently. For a review of the tax reduction mechanism used in the FSC, see infra note 68.
A. The Disc as a Paradigm for Export Tax Incentives.

The DISC program provides many valuable lessons for U.S. policy planners in using the tax code to stimulate a specific sector of the economy. Because the DISC has been a source of considerable friction between the U.S. and its European trading partners, the Reagan Administration has asked Congress to repeal this incentive. Nonetheless, in terms of its basic structure and its effect, the DISC is a useful paradigm.

1. The Structure of the DISC.

The Nixon Administration proposed the DISC in 1972 in order to give U.S. exporters, especially small businesses, a counter-weight to the advantages foreign producers enjoyed through subsidies and other concessions provided by their governments. The Administration also intended that the DISC provide small businesses with an incentive comparable to the tax benefits that the large multinationals could acquire through the use of foreign subsidiaries. The DISC program, designed to expand U.S. export activity by reducing the cost of export capital, encouraged U.S.-based corporations to reach foreign markets through exporting rather than through direct foreign investment or joint ventures. It was hoped that by stimulating U.S. export activity the DISC would lessen significant balance of payments and balance of trade problems. Despite some revision by the Congress in 1975 and 1976, the DISC's focus and purpose have remained essentially unchanged.

A DISC is a domestic corporation which meets certain minimal structural requirements and limits itself almost exclusively to export activity. If a DISC derives at least 95 percent of its income from export activity, and if 95 percent of

11. Id.
12. Id.
13. Id.
14. The Tax Reduction Act of 1975 denied DISC benefits to profits arising from products in short domestic supply and from exports of natural resources. The Tax Reform Act of 1976 made DISC benefits limited to income attributable to export gross receipts in excess of 67 percent of average gross receipts in a four year base period. DISC's with adjusted taxable income of $100,000 or less are exempt from this rule. Also, DISC benefits on the sale of military goods were limited to one-half the amount otherwise allowed. The other substantive change was that the period of recapture of the deferred tax was lengthened to twice the number of years of the DISC's existence, up to a maximum of ten years. OPERATION AND EFFECT, supra note 8, at 5-6.
15. To qualify for DISC status, a DISC must be incorporated under the laws of any State or the District of Columbia, have only one class of stock, have a $2,500 paid-in capital value, maintain its own bank account and accounting records, and file an election to be treated as a DISC with the IRS. Wagner, supra note 10, at 109.
16. Id.
its adjusted basis assets at the close of the tax year are export related, the corporation may defer taxes on 42.5 percent of its export income indefinitely. A DISC need not have either employees or real operations as long as the 95 percent export assets/receipts requirement is met.

The sale of export property between the DISC and its parent may be priced according to the most beneficial of three formulas for the DISC, granting corporate managers great latitude in the construction of export sales strategy. Moreover, DISC income is taxed only when export income is distributed to shareholders or a DISC is terminated. Combined with the rather relaxed requirements for establishment of the DISC, the tax deferral and export property sale provisions of the program make exporting through a DISC very attractive.

2. The Economic Benefits of the DISC.

To the individual exporter, the DISC offers great economic benefits. Statistics published by the Treasury Department for DISC year 1981 show that 71.1 percent of total U.S. exports of manufactured goods were accomplished through the DISC, and that the DISC incentive was directly responsible for between seven to 11 billion dollars of export activity. As of February 1983, some 17,163 DISC

17. To be eligible for the tax deduction, receipts must be derived from the sale or lease for use outside the U.S. of export goods, or from the furnishing of services related or subsidiary to the sale or lease of export property. Dividends on stock of a related foreign export corporation and interest on obligations which are qualified export assets are also considered qualified. Under the law, commission receipts are also included. DISC Substitute Detailed in Administration Draft Proposals, Tax Notes, June 18, 1983, at 240 [hereinafter cited as DISC Substitute].

18. If a DISC is not owned by a corporation, however, taxes on 50 percent of its income may be deferred. Wagner, supra note 10, at 109.

19. DISC Substitute, supra note 17, at 240; see also I.R.C. § 992 (1971).

20. Export property is generally defined as goods that are manufactured, produced, grown, or extracted in the United States solely for export. Exports that are directly subsidized by the U.S. government or exports that are intended for later use in the United States do not qualify as export property. DISC Substitute, supra note 17, at 240; see also I.R.C. § 993 (1971).

21. OPERATION AND EFFECT, supra note 8, at 4.

22. By allowing corporate tax planners to manipulate intercompany pricing policies, a high degree of flexibility is achieved in the manufacturer-DISC relationship. This flexibility allows corporate planners to consider marketing strategies with the understanding that their tax burden will always be minimal—essentially doing away with the taxation variable in the investment and marketing equation.

23. DISC Substitute, supra note 17, at 240; see also I.R.C. § 992 (1971).


25. In testimony before a House subcommittee, one businessman stated:

The experience of my own company . . . shows the benefits a DISC can produce. When we first established a DISC our exports were only 36 percent of our total sales. Today, exports constitute over 70 percent of our total sales. Our domestic sales have grown only 26 percent in this period while our export sales have grown 424 percent. Thus the value of export tax incentives

Hearings, Tax Incentives, supra note 6, at 71 (testimony of Frank A. March, National Ocean Industries Association).

26. OPERATION AND EFFECT, supra note 8, at 8.

27. Id.

28. Id. at 13.
corporations had been registered with the Internal Revenue Service. Moreover, the fierce resistance by the business lobby to the proposed elimination of the DISC by the Carter Administration is further evidence that the program has worked to the benefit of the export production community.

There is, however, strong disagreement among experts over the macro-economic effects of the DISC program. The debate focuses on the usefulness of tax code manipulation as a means of channeling investment capital into particular sectors of the economy. Consequently, in order to evaluate the potential of the FSC, it is necessary to review the economic lessons of the DISC program.

Assessing the long term effects of the DISC is empirically problematic. For example, in the years of the DISC's existence, the U.S. share of free world exports of manufactures has actually declined. Indeed, the program has been criticized because the anticipated dividends of the DISC have not proven to be as great as expected.

First, it has been argued that the basic macro-economic effect of the DISC is a long-run reduction in U.S. economic well-being. According to critics, as the amount and value of U.S. manufactured goods sent overseas rises, use of a DISC reduces the price of American goods to foreign consumers, leading other countries to respond in turn by exporting more to the United States. As the cost of goods produced by a foreign manufacturer must fall to meet the price of a DISC-subsidized good, while the cost of a good made in the U.S. for domestic consumption without the benefit of a tax incentive would not change, the level of

29. In testimony before the House Ways and Means Committee, one executive asserted:

Foreign sales and foreign market development cannot be a faucet that we turn on and off . . . . [R]ecurrent attack on the DISC . . . is a severe deterrent to the business man in my part of the country, and the country at large.

It is our firm belief that such actions [i.e., repeal of the DISC] will drive many U.S.-based companies out of a number of foreign markets in which they are active today and further encourage major foreign penetration into weakened U.S. markets.

30. It is impossible to estimate how much export business would have been done without the DISC because the analysis requires a subjective evaluation of the export decision-making process of large numbers of business executives. The only objective evidence lies in their own comments on the subject, and these comments emphasize the indispensable nature of the DISC incentive. Hearings, Tax Incentives, supra note 6, at 17-63 (letters concerning the proposed repeal of the DISC).


34. Id. at 21-22.

35. Id. at 19-20.
U.S. imports would necessarily rise. Consequently, as a result of the DISC, output of goods by American producers for the domestic markets would actually decline. Thus, in the long run, U.S. balance of trade and balance of payments levels are eroded.

Second, it is claimed that the DISC has a detrimental effect on the net welfare of the domestic and international economy. According to this argument, insofar as the DISC incentive draws capital into the export sector of the economy and away from other sectors it causes inefficiencies as well as resulting in lost tax revenues. For the DISC to improve welfare effects it would be necessary for the program to produce enough taxable income to offset the revenue lost by the treasury as a result of the incentive. In sum, the long-term effect of the government's manipulation of the tax code to improve export performance is actually deterioration of the health of the entire U.S. economy.

The attacks against the DISC, usually based on claims that it causes inefficiencies, harms balance of trade and balance of payments levels, and causes negative welfare effects, are indeed serious. Yet, in light of a study by Price-Waterhouse, these arguments seem unfounded. The Price-Waterhouse study demonstrates the positive influence of the DISC incentive on domestic economic efficiency, U.S. balance of payments and balance of trade levels, and on the long-term welfare of the American economy.

36. The outcome from Mutti and Grubert's model, which assumes production of all goods requires three factors of production (unskilled labor, skilled labor, and capital), and each nation produces three goods (a net export good, a net import good, and a non-traded good) with homogeneous capital, shows that as output of net export good rises, output of net non-traded, or domestic goods declines. Id. at 19.

37. The "balance of trade" is simply the difference between the dollar value of exports and imports in a given year. It is important to understand that the balance of trade refers only to the difference between exports and imports, and not the volume of trade. R. LIPSEY & P. STEINER, ECONOMICS 774 (6th ed. 1981)

38. The "balance of payments" represents the measure of the transactions going on between countries. Any transaction that is expected to lead to a payment to other nations represents a debit, because it subtracts from foreign exchange reserves. Similarly, any transaction that is expected to lead to a payment by foreigners to the U.S. is classified as a credit. Id. at 772.

39. Because the DISC is an artificial incentive, it draws capital away from the sectors of the economy in which, all else being equal, business would tend to invest. By distorting the market, the incentive creates inefficient allocations of capital.

40. The estimated revenue cost of the DISC in DISC year 1981 was $1,650 million. OPERATION AND EFFECT, supra note 8, at 1.

41. It is argued that to the extent that the DISC draws capital away from foreign markets, the capital will come on the average from countries in which the corporate tax rate is at least as high as the rate in the United States. J. Mutti & H. Grubert, supra note 33, at 24. Moreover, whatever positive effect the DISC might produce, the income distributional shifts and the output adjustments caused by the tax incentive are far too harmful to be justified by the benefits of the incentive. Mutti and Grubert assert that in the final analysis, "A basic condition for DISC to improve . . . welfare is [that] DISC must result in the reallocation of capital away from low tax uses toward high tax uses." Id. at 23–24.


43. See supra note 1.

44. It must be remembered that the DISC is designed to reduce the cost of capital employed in export activities, thus making investment projects, insofar as they are evaluated in terms of the cost of
The pernicious effects of the DISC incentive on capital investment cited by the DISC's opponents are overstated. In an economy operating at full capacity, the DISC tax incentive would draw capital out of other productive enterprises. Yet, the economy of the U.S. is operating far from capacity and it may be assumed that DISC is bringing into production resources that otherwise could well have stood idle.

The argument that DISC reduces economic efficiency is also unfounded. While it is true that DISC-type incentives will cause market distortions that create inefficiency, the U.S. economy is already full of market distortions which skew the benefits of investment to particular sectors of the economy. DISC actually facilitates domestic economic efficiency by changing the law to give tax adjustments on the profits from private export activity, in much the same way that tax advantages are given to other private producers or governmental units.

Insofar as the DISC incentive promotes a net increase in export revenue, it will improve the balance of payments situation. Some argue that the effects on foreign production of goods for the U.S. market triggered by the DISC incentive would offset any benefit for domestic export production firms that the program might produce. Yet, as the Price-Waterhouse study points out, the initial effects of the DISC on the balance of payments are positive. While there is an initial deterioration in the U.S. terms of trade, over the long term the increase in the

capital, more attractive. The testimony of business decision-makers cited earlier, *Hearings, Tax Incentives, supra* note 6, at 146 (Price-Waterhouse study), tends to validate the underlying proposition. In an economy with so much excess capacity, it is clear that the "allocation of capital is not a zero-sum game in which increased capital formation in one sector requires decreased capital formation in another sector." *Id.*

45. The Price-Waterhouse study points out that the complicated system of tax credits and exemptions written into the tax code serve to equalize after-tax rates of return from different sectors of the economy. Thus, the optimal distribution of productive inputs is subverted to the extent that the tax code actually serves to redistribute returns on investment. Consequently, it is extremely difficult to determine the efficiency effects of any specific tax incentive because of the distortions inherent in the system. *Id.* at 147.

46. The tax code is biased against private capital in favor of public capital to the extent that schools, hospitals and roads are exempt from taxes, while private concerns are not. Therefore, any proposal which reduces the marginal rate of taxation on any portion of private capital investments would promote a more efficient allocation of capital in the U.S. by compensating for that bias. T. Horst, *An Economic Analysis of the Foreign International Sales Corporation Proposal* (Sept. 1981) (unpublished paper), *cited in Hearings, Tax Incentives, supra* note 6, at 149.

47. The Treasury Department estimates that repeal of the DISC would result in a loss of between $77 and $11 billion of export revenue. *Operation and Effect, supra* note 8, at 12.


49. The distribution of the gain as a result of trade between two nations is determined by the "terms of trade," that is, the quantity of domestic goods that must be exported to get a unit of imported good. R. Lipsey & P. Steiner, *supra* note 37, at 738.

50. The deterioration in the terms of trade of the U.S. is produced by a reduction in the price of U.S. export goods, while the price of import goods remains constant. Eventually, however, the reduction in the price of each American export good will be offset by increased foreign demand for those goods, and U.S. terms of trade will improve. *Hearings, Tax Incentives, supra* note 6, at 140 (Price-Waterhouse study).

51. See *supra* note 37 and accompanying text.
quantity of U.S. exports as a result of the DISC will improve the terms of trade as well. 52

Finally, it is difficult to argue that a program damages the economy's health when, in fact, the incentive returns to the domestic economy seven to 11 dollars for each tax dollar invested. 53 The DISC would therefore seem to produce, as Price-Waterhouse argues, significant economic benefits. 54 In light of the DISC's effects on capital flow and economic efficiency, U.S. balance of payments and balance of trade, and U.S. economic health, it must be concluded that the DISC, or a DISC-style incentive, is a valuable catalyst to the U.S. economy.

The DISC is consequently an example of the potential benefits of using the tax code to stimulate investment and production. It demonstrates that generous tax incentives will encourage investment, benefit the business community, and contribute to the health of the U.S. economy. The DISC program should therefore provide the standards against which the efficacy of the proposed Foreign Sales Corporation should be judged.

B. The Structure and Benefits of the FSC

The essential structural differences of the proposed FSC from the DISC are reflected in the foreign presence requirements, structural requirements, transfer pricing rules, and most significantly, in the provisions governing the distribution of dividends. The FSC must meet each of three foreign presence requirements 55 in order to ensure that its tax exempt income arises from foreign economic processes. 56 These requirements are designed to meet the terms of the General Agreement on Tariffs and Trade (GATT) "Understanding" 57 regarding the taxation of extra-territorial income. By forcing the FSC to be technically a foreign

52. As the cost to the Treasury of the DISC program is about $11 billion a year, and it produces between seven and $11 billion in additional export revenue, each DISC dollar has a multiplier effect of between seven and 11. Many studies of the American economy have been made that suggest the ordinary Gross National Product multiplier is between 1.5 and 2. See R. Lipsey & P. Steiner, supra note 37, at 531.

53. When surveyed as to the appropriate role of the government in stimulating exports by small businesses, the business community rated tax incentives as the single most appropriate and effective policy option available. See Hearings, Tax Incentives, supra note 6, at 70 (testimony of Frank A. March, National Ocean Industries Association).

54. Treasury Department statistics show that 43.6 percent of all DISC returns showed a net income of less than $100,000, proving the small exporter has effective access to the incentive. See Operation and Effect, supra note 8, at 23.

55. The FSC must be managed outside the United States. The three tests for this foreign presence requirement are that all meetings of the board of directors of the corporation and shareholders be held outside the U.S.; that the principal bank account of the FSC be maintained outside the U.S.; and that all dividends, legal and accounting fees, and salaries be disbursed from a bank account outside the U.S. Foreign Sales Corporation Act of 1983, supra note 4, at § 924(c)(1)-(3).

56. The FSC must also meet a foreign economic processes test, which under § 924(d) demands that the corporation participate outside the U.S. in the solicitation, negotiation, or the making of the contract relating to an export transaction; and that the foreign direct costs incurred by the FSC attributable to the transaction equal or exceed 50 percent of the total direct costs incurred by the FSC attributable to the export transaction. Id. at § 924(d)(1)-(2).

57. On January 1, 1972, the DISC became law, and by February 4, the European Economic Community had turned to the General Agreement on Tariffs and Trade (GATT) adjudicatory mecha-
operation, GATT objections to the deferral of taxation on domestic income earned through export activity are effectively defused.58

A FSC must also meet four structural requirements under the proposed rules. In order to qualify for the tax advantage, the FSC must maintain an office outside of U.S. territory;59 have the foreign office maintain a summary of its permanent books of account;60 have at least one director who resides outside U.S. territory,61 and maintain an office within the U.S. where the corporation’s records are available for inspection.62 The drafters of the FSC have tried to accommodate small businesses through the inclusion of provisions for a “small FSC”63 and by exempting from the new rules established DISC’s with under ten million dollars in qualified export receipts.64

The importance of the transfer pricing rules, which govern the sale of export property to a FSC by a corporate parent or other I.R.C. § 482 “person”,65 lies in the fact that these rules determine the size of the foreign gross trading receipts earned by the FSC. It is this income, earned from transactions between the parent and the FSC, that is subject to federal taxation.66 Under the FSC transfer pricing system, the taxable income of the FSC and its parent is based on a transfer price that allows the FSC income no greater than either 1.83 percent of foreign trading

nisms to force the U.S. to end the DISC program. The U.S. countered by charging that the tax policies of France, Belgium and the Netherlands were in violation of the GATT rules.

In four reports issued on November 2, 1976, the GATT Panel found that all the tax practices brought to its attention were violations of GATT Article XVI:4—the prohibition on export subsidies. In 1981 the U.S., subject to an “Understanding,” agreed to the adoption of the 1976 report. The “Understanding” stated that GATT signatories were not required to tax export income attributable to economic processes located outside their territorial limits; that the “arm’s-length” pricing principle should be observed in transactions between exporting enterprises and foreign buyers under common control; and that the GATT would not prohibit the adoption of methods to avoid the double taxation of foreign source income. DISC Substitute, supra note 17, at 241.

58. Under the GATT “Understanding”, a country does not have to tax income earned outside its borders. It is to take advantage of this provision that the Reagan Administration proposal requires the FSC to be managed outside the United States. Id. at 242.

Consequently, by requiring that the Foreign Sales Corporation operate outside U.S. territory and that the tax-exempt income be attributable to “foreign economic processes”, see supra note 56, the attacks by the EEC on U.S. export policy are rendered ineffective. DISC Substitute, supra note 17, at 241.

60. Id. at § 922(a)(1)(D)(ii).
61. Id. at § 922(a)(1)(E).
62. Id. at § 922(a)(1)(D)(iii).
63. A “small FSC” is one which is not a member, at any time during the taxable year, of a controlled group of corporations which includes another FSC, unless the other FSC has also made a small FSC election which is in effect for the tax year. Id. at § 922(b)(2). If its foreign trade gross receipts do not exceed $2,500,000 a taxable year, then the FSC may use the administrative pricing rules without regard for the foreign presence requirements. Id. at § 924(b)(2)(B)(i).
64. See generally id. at § 927 section 2. By allowing this exemption from the foreign presence requirements for the small exporter, the very significant problems that such requirements would pose for the small business are solved.
65. Section 482 of the I.R.C., the “Allocation of Income and Deductions among Taxpayers” provision, covers all “organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated)” that are “owned or controlled directly or indirectly by the same interests.”
gross receipts derived from the sale of export property, 23 percent of the combined taxable income of the FSC and its parent which is derived from the sale of export property or taxable income based upon the sale price actually charged the parent.67

The DISC data indicates that reductions in the cost of capital to the exporter through enhancement of profit levels are essential to the success of any policy designed to promote private sector export production. The effectiveness of the FSC incentive therefore must be judged by its effect on the difference or "wedge" between pre-tax and after-tax return on export production profits. The FSC will promote export production only to the extent that it reduces the size of the tax wedge.

The most crucial provision of the FSC, in terms of the reduction of the tax wedge, is the rule governing the distribution of dividends from export earnings. Corporate shareholders of a FSC are allowed to take the dividends distributed by the FSC free from federal tax liability.68 Since the federal tax wedge between pre-tax and after-tax earnings is removed, companies could conceivably earn higher profits from export activity than from foreign investment despite the fact that the pre-tax rate of return on the latter may be greater. Since business investment decisions are made based upon the after-tax return of possible investment opportunities,69 the use of a FSC incentive can thus encourage export production.

While the FSC does promise U.S. exporters great benefits, the bill contains a major flaw. As the "export property" requirements are stated in the Administration's proposal, fully "50 percent of the fair market value [of the products brokered by a FSC] may be attributable to articles imported into the United States".70 Thus, a large, vertically integrated multi-national corporation could use cheaper foreign labor and materials to complete the major manufacturing processes, and then use American labor in the finishing process to meet the 50 percent domestic value requirement. In the steel industry, for example, a multinational could use Korean mills and labor for the initial production, and only then

67. Id. at § 925(a)(1)-(3).

68. Foreign Sales Corporation Act § 927(c) states: "[T]here shall be allowed as a deduction an amount equal to 100 percent of any dividend received by such corporation from another corporation which is distributed out of earning and profits attributable to foreign trade income . . . . The deduction allowable under the preceding sentence with respect to any dividend shall be in lieu of any (other) deduction." Id. at § 927(c).

Aside from the costs imposed by the foreign presence requirements, the wedge between pre-tax and after-tax return is completely removed by the FSC dividend provisions. The dividends of a FSC corporation are effectively tax-free, thus increasing the profit on each dollar invested in export production by the percentage of the profit that ordinarily would have been taken in taxes. Because profits are higher, the opportunity costs of committing capital to export production are significantly reduced.

69. See supra note 3.

70. The FSC legislation defines "export property" to include property manufactured, grown, or extracted in the U.S. by a person other than [the FSC which is] held primarily for sale, lease, or rental in the ordinary course of business by or to a FSC, for direct use, consumption, or disposition outside the U.S. Id. at § 927(a)(1)(A)(B). Labeling a product which is 50 percent foreign substance or construction to be "manufactured, produced, grown, or extracted in the U.S." is indeed an interesting bit of legislative drafting.
use American workers to carry out some minor finishing tasks. As the difference in wages earned by a Korean factory worker and a member of the United Steel Workers is significant, the massive tax benefits of the FSC would induce the corporation to go no further than the 50 percent domestic value requirement.

It is crucial to the long-run success of U.S. export policy that tax incentives be allowed only for the export of goods and services in which the vast majority of the value is derived from the efforts of American workers. Without this requirement, the U.S. taxpayer could end up subsidizing foreign manufacturing operations rather than export production activities of American business and labor. The problem with the proposed FSC domestic content requirements can be easily solved by requiring all export property used by a FSC to be substantially of American manufacture and assembly. Such a requirement would promote domestic industry while working little hardship on the corporate community.

Notwithstanding the export property composition issue, the FSC can be a valuable asset for the U.S. exporter. Although the stiff foreign presence requirements and greater complexity of the FSC make the structural costs of the program greater than the costs of the DISC, the tax-free dividend is sufficient to effectively enhance the profitability of export production. Further, insofar as the FSC meets GATT objections to current U.S. export policy, it can contribute not only to domestic prosperity, but to improved trade relations as well. The FSC should therefore make a productive addition to U.S. export policy.

II. The State Unitary Taxation of Foreign-source Income

In order for the new export policy to be effective, it is necessary to provide a disincentive to direct foreign investment by large U.S.-based corporations in addition to the FSC export incentive. The DISC experience has proven that an export tax incentive alone will not have a major impact on the U.S. balance of payments and balance of trade, or even on the U.S. share of the world market. Only insofar as the tax system can equalize the after-tax return between direct foreign investment and domestic investment for export can the goals of the DISC

71. According to figures supplied by the American Institute of Iron and Steel, the per hour cost of an American worker in terms of wages and benefits is $21.68. Republic of Korea (South Korea), a major exporter of steel to the U.S., pays its workers far less. Estimates of the pay scales of Korean steelworkers have ranged down as far as $2.80 per hour.

72. The foreign presence requirement of the FSC increases structural costs far beyond those produced by the relatively simply requirements of the DISC. See supra note 56.

73. Currently, the pre-tax return on foreign investment is, for a number of reasons, higher in many instances than the return on investment in domestic production for export. See infra note 108. By changing the rate at which foreign-source profits and domestic export productions are taxed, the FSC can make the actual net return on export production greater than the net return on foreign investment. Thus, the fact that foreign investment brings higher pre-tax return becomes irrelevant to the rational profit-maximizing business.

74. See supra notes 57–58 and accompanying text.

75. See supra note 31 and accompanying text.

76. See supra note 32 and accompanying text.
program be achieved.\textsuperscript{77} The FSC represents the incentive element in a tax policy aimed at increasing export activity; the disincentive element should be state unitary taxation of corporate foreign-source income.

\textbf{A. The Unitary Tax as a Disincentive to Direct Foreign Investment.}

A number of states\textsuperscript{78} have found the unitary system an effective way to enhance tax revenue at the expense of multi-jurisdictional corporations.\textsuperscript{79} Under the traditional "arm's-length" system of taxation, a business is taxed based upon its dealings within the legal borders of the taxing jurisdiction.\textsuperscript{80} When applied to vertically integrated multi-jurisdictional corporations, however, the "arm's-length" system has proven to be ineffective for bringing in tax revenue in proportion to corporate earnings.\textsuperscript{81} The unitary system, by contrast, operates on the

\textsuperscript{77} In essence, only if the after-tax return on domestic investment, $R_d$, plus the FSC tax incentive, $F$, is greater than the return on foreign investment, $R_f$, will the rational profit-maximizing businessman invest in the United States and export rather than invest directly in a foreign nation.

\textsuperscript{78} Currently, 12 states have implemented world-wide unitary taxation: Alaska, California, Colorado, Florida, Idaho, Indiana, Massachusetts, Montana, North Dakota, Oregon, and Utah. Illinois, Minnesota and New York are among a group of states that uses a modified form of the unitary system, limiting the system's application to U.S. operations only. \textit{See New Tax in 12 States Angers Big Business}, Ann Arbor News, Jan. 29, 1984, at E9 [hereinafter cited as \textit{New Taxes}].

\textsuperscript{79} For the purposes of this section, "multi-jurisdictional corporation" should be understood to mean any corporation that has business operations in more than one State. This definition also encompasses the traditional multi-national corporation.


\textsuperscript{81} According to James B. Zagel, Director of the Illinois Department of Revenue, the "arm's-length" method of taxation leads to the following:

Exxon, I believe—and I think these are the facts—did somewhere between $14 and $16 million a year of sales in the State of Wisconsin. They had something like ten to $12 million worth of property, and their initial tax return showed they owed no taxes to the State of Wisconsin.

Now the fact of the matter is, that this is the kind of phenomenon that occurs with unitary businesses.

\textit{Id.} at 126.

The "arm's-length" method is highly vulnerable to abuse because of its reliance on essentially artificial and formalistic distinctions within vertically integrated corporations. As one Treasury Department report put it: "[V]ery substantial tax benefits turn upon an artificial factor: whether a foreign corporate charter has been interposed between foreign income and the U.S. taxpayer." \textit{Id.} at 100. Consequently, the "arm's-length" system actually promotes a corporate shell game, in which profits are hidden behind various corporate charters.

In testimony before the House Ways and Means Committee, William D. Dexter, the General Counsel of the Multistate Tax Commission, described the "shell game" in action:

[A] major domestic oil corporation . . . translated internal domestic sales into sales of its foreign affiliated corporations by transferring crude oil produced in the United States and refined and marketed in the United States to sales of crude oil from its foreign subsidiaries. It accomplished this result by a paper transfer of the crude oil to foreign subsidiaries in the
principle that a corporation that is unified in a business sense should be treated as a single entity for tax purposes. Tax responsibilities are calculated not with reference to political boundaries, but rather by a formula that looks to local percentages of total corporate payroll, sales, and property holdings. Unitary taxation has been called the "wave of the future" because it is the most effective system for collecting proper amounts of tax revenue from multi-jurisdictional enterprises.

Large corporations, especially the multinationals, strongly attack the use of the unitary system because it raises their aggregate tax responsibility and "complicates decisions on matters such as future plant locations". It is precisely because the unitary system will raise corporate taxes and, at the same time, eliminate the tax differences between legal jurisdictions that it can operate as a disincentive for direct foreign investment.

To illustrate the effects of the unitary system, assume that without unitary taxation, a corporation can realize ten million dollars more of after-tax return on a particular foreign investment than on a comparable domestic investment. If the corporation is then taxed under the unitary system by all the states in which it does business and if federal taxes are held constant, much of the extra earnings from foreign operations will have to be used to satisfy that corporation's increased state tax responsibility.

If at the same time a sufficiently large FSC-type incentive is offered for export activity, so large that the reductions in federal taxes would offset the increased state tax liability, domestic investment in export production would become more profitable, after taxes, than direct foreign investment. The combination of the FSC and the unitary tax would make the after-tax return on export production greater than the return on direct foreign investment. Consequently, the rational profit-maximizing corporation will invest within the United States.

course of the movement of the crude oil in its tankers on the high seas as the crude oil moved from its domestic production fields to its domestic refineries in the United States. Id. at 25. By placing the oil under the "control" of the foreign subsidiary, it became immune from U.S. taxation.


84. Hearing, State Taxation, supra note 80, at 57 (California State Franchise Tax Board Position Paper). Indeed, California, which has had some 30 years experience with the unitary tax, estimates that the use of the unitary system, in 1977, produced almost $500 million in additional tax revenue each year, with most of the revenue coming from multi-jurisdictional enterprises. Id. at 67-68 (Report on "Revenue Impact of Section 2173," submitted by the State of California Franchise Tax Board).


86. The unitary system treats domestic earnings and foreign source earnings equally. Consequently, the difference between the after-tax return on a foreign invested dollar and a domestic dollar is significantly reduced and the effect of the FSC incentive is magnified. Thus, return on domestic investment, $R_d$, plus the FSC, $F$, will often be greater than the return on foreign investment, $R_f$. 

The unitary system of taxation of foreign-source income by state governments has proven to be constitutional,\(^74\) effective,\(^8\) and quite fair.\(^8\) Indeed, the simplicity of the system has led to suggestions that the federal government adopt the unitary method in order to end the reliance by the courts on the “ad hoc . . . approaches” necessary for adjudicating tax disputes under the “arm’s length” system.\(^90\) Federal government implementation of the unitary system, however, would require a suspension of political reality. Current treaty obligations would make such a policy at best problematic, and at worst lead to serious international trade disruptions.\(^91\) Moreover, Congressmen would be subject to an enormous amount of political pressure from the corporate community to block the institution of the unitary tax. The fate of the Carter Administration’s proposal to end the foreign tax credit is evidence of the effectiveness of the corporate lobby.\(^92\)

87. California’s system of unitary taxation, based on a three factor formula that assesses taxes on the local percentage of total payroll, sales, and property, was upheld against constitutional challenge in Container Corp. of America v. Franchise Tax Board, 51 U.S.L.W. 4987 (U.S. June 28, 1983). In Container Corp., the unitary system was challenged as causing unfair double taxation of corporate income and as violating the Commerce Clause and Foreign Commerce Clause.

In its decision, the Supreme Court asserted that while the possibility of double-taxation was real, it was necessary to take into account the context in which the taxation took place, and the reasonable alternatives available to the state. Because “[allocating] among various taxing jurisdictions bears some resemblance . . . to slicing a shadow,” the Court found no reason to force California to cease using the unitary system.

Moreover, the California system met the Commerce Clause test of Exxon Corp. v. Department of Revenue of Wisconsin, 447 U.S. 207, 219–20 (1980), and the Foreign Commerce Clause test of Japan Line Ltd. v. County of Los Angeles, 441 U.S. 434, 445–46 (1979). The Court therefore gave a final stamp of constitutionality to the use of the unitary system by the states to tax U.S. multijurisdictional corporations. See also Hellerstein, supra note 83.

88. The effectiveness of the unitary system may be gauged by the estimates that the states that use the unitary system produce regarding the extra revenue obtained as a result of unitary taxation, see supra note 84, and by the fierce opposition of the corporate community to the expansion of that system. See New Tax, supra note 78, at E9.

89. As one state tax commissioner stated, “The [unitary system] is not perfect. It simply is the best yet discovered for dealing with the unitary business.” Hearing, State Taxation, supra note 80, at 21 (statement of Byron Dorgan, Past Chairman, Multistate Tax Commission, also Tax Commissioner, State of North Dakota).


91. A common thread in the testimony of representatives of multinational business before the House Ways and Means Committee was that “progress has been made in securing a degree of international consensus that tax jurisdiction is exercised only where there is actual physical presence.” Indeed, institution of the unitary system could lead to wide-scale retaliation by other nations. Consequently, the multijurisdictional corporate community vigorously opposes use of the unitary tax in order to save the government of the United States from diplomatic embarrassment. Hearing, State Taxation, supra note 80, at 179 (statement of Charles S. Levy, Vice-President, Emergency Committee for American Trade).

Indeed, the use of the unitary tax by the states has already caused some international difficulty. Twelve countries have filed complaints with the U.S. government about the unitary system, and two of the 12 have halted renegotiations of tax treaties. New Tax, supra note 78, at E9.

92. The Carter Administration proposed the elimination of the foreign tax credit, asserting that
The states, however, are uniquely situated to implement the unitary system of taxation. There is a pressing need to raise revenues to fund state services, and the multi-jurisdictional corporations have recently become more attractive to state legislators as potential sources of tax monies. Moreover, because local voters see little personal repercussions from additional taxes on "outside" corporations, and since strictly local businesses would support measures that reduced their tax burden, the political benefits a state legislator gains from taxing a "foreign" corporation could well outweigh the arguments of a multi-jurisdictional corporation's lobbyist. Finally, the states are free from the restraints of international treaties and obligations which constrain Federal treatment of foreign source income.

Several major objections can be raised to the use by the states of the unitary tax system as a tool of U.S. export policy. First, in order to assure the scheme's success, there must be almost absolute uniformity of use. Absent uniformity, corporations could simply locate in a non-unitary state, and effectively negate the possibility that state taxation would equalize the after-tax return on domestic and foreign investment.

The evidence indicates, however, that uniformity is an achievable goal. Currently, twelve states have implemented a worldwide unitary system, and nineteen states are members of the Multistate Tax Commission, an organization dedicated to the promotion of the unitary system. These states have enacted a uniform body of law, known as the "Three Factor Formula", to govern tax collection. Thus, an aggressive lobbying campaign in favor of the unitary system could achieve the necessary results.

The unitary system has also been subject to attack on the grounds of its perceived unfairness to multinational business. It is argued that the unitary tax is...
unfair because corporations that are similarly situated with regard to the local taxing authority are treated differently as a result of the performance of an extra-territorial subsidiary. Fairness, it is argued, demands that a corporation be taxed solely on the performance of its local facilities.

It is true that taxation of world-wide income could well produce different tax responsibilities for corporations similarly situated in a particular domestic jurisdiction. It is not true, however, that this is unfair. In terms of the corporate balance sheet, geography is irrelevant. Consequently, there is no logical reason to prevent a state taxing authority from treating multinational corporate operations within its jurisdiction as elements of an integrated whole.

Corporations also claim that the unitary tax is unfair because the calculation of foreign-source income is distorted by the higher wage rates and property values in the U.S. and by the necessity for high rates of return on investment in unstable foreign markets. The unitary system, by ignoring those factors, produces artificially inflated tax responsibilities. The distortions caused by U.S. wage rates and property values, however, are not distortions at all but merely represent the cost of using American workers or factories to produce goods. Further, by insisting that the tax system recognize the necessity of high rates of return on foreign investment, the corporate community is asking the domestic tax payer to subsidize the movement of investment capital into risky ventures overseas when that capital could have been invested in the U.S. Fairness demands the use of the unitary tax to reach corporate foreign-source income.

100. Id. at 155 (statement of Ernest S. Christian, Jr., Counsel, Committee on State Taxation of the Council of State Chambers of Commerce).
101. Id. at 154–55.
102. Id. at 165 (statement of Paul W. Cook, Treasurer, National Association of Manufacturers).
103. Under the "arm's-length" system of taxation of foreign source income, abuse is rampant. See supra note 81. As a U.S. Treasury Department report put it, "very substantial tax benefits turn upon an artificial factor: whether a foreign corporate charter has been interposed between foreign income and the U.S. taxpayer." Hearing, State Taxation, supra note 80, at 100 (The President's 1978 Tax Program, Department of the Treasury, submitted by the California Franchise Tax Board). Under the current system, the small businessman by paying his sales tax, personal income tax, and property tax could end up subsidizing the activities of a multi-jurisdictional corporation within his state, because through the manipulation of the tax law, the large corporation may avoid its state tax responsibility.

A multi-jurisdictional business operates in a unitary manner, with the benefits of operations in a particular locality being distributed throughout the corporate body. To allow such corporations to use the tax law to compartmentalize liability on the basis of political boundaries and thus minimize their responsibility is true unfairness.

104. Id. at 165.
105. Id.
106. Id.
107. It is precisely as a result of the lower return on investment on domestic production that many businesses invest overseas. The recent actions of the American electronics industry are instructive. In 1980, the U.S. had a $6.8 billion trade surplus on computers, consumer electronics, telecommunications equipment and microchips. By 1983, that surplus had shrunk to two billion dollars, and it is expected that 1984 will produce no surplus at all. Much of this precipitous decline may be attributed to "American companies setting up abroad—either to sell into local markets or to use low-cost labour to assemble components for re-importing into America. Malaysia, for example, accounts for $1.1 billion of the value added in the $26.4 billion . . . world semiconductor market, but has no indigenous chipmaker." The Surprise Importer, ECONOMIST, Mar. 10, 1984, at 67.
Finally, it is argued that as a result of using the unitary system and raising corporate tax rates, significantly higher taxes for the multi-jurisdictional business community would be inevitable. Higher taxes have a detrimental effect on corporate investment decision making. Thus, the negative net effect of the additional taxes to the economy as a whole would offset the benefits accruing to the export sector.

Examination of this objection proves it to be groundless. The institution of a unitary tax and a higher rate of taxation will certainly mean more taxes for many large corporations. Yet the overall tax bill of small corporations could well decrease as a result of the unitary tax. 108 Personal and property tax burdens could also be eased, because more state tax revenue would be paid by the large multi-jurisdictional corporations. Since small businesses provide seven out of every ten new jobs for American workers, 109 the effects of the increased tax on employment levels would be minimal. In fact, the only real "harm" that would occur as a result of the institution of the unitary tax would be to the profits earned from foreign operations by large multi-jurisdictional enterprises.

III. THE FOREIGN SALES CORPORATION INCENTIVE AND THE STATE UNITARY TAXATION DISINCENTIVE AS A POLICY PACKAGE.

In order for the new export policy to be effective, it is necessary that both the unitary tax system disincentive and the FSC incentive be in place simultaneously. Without the FSC incentive for investment in export production, the unitary system of taxation will do nothing to encourage export activity. With only a unitary system in place, corporate tax liability would increase, but the present levels of return on export production would remain constant, at levels generally below the return achieved on foreign investment. 110 Similarly, the benefits of export incentives like the FSC or DISC are insufficient to equalize the return on foreign and export production investment. 111 Without the unitary system bringing foreign and domestic investment return into rough parity, the full potential of the FSC incentive would not be met.

108. Because the multi-jurisdictional corporation would be paying more in taxes under the unitary system, strictly local business would have to bear less of the burden for funding state services. Property taxes and small business tax rates could well be expected to decrease, once the larger corporations pay their share. Thus, strictly local business generally supports the unitary system. New Tax, supra note 78, at E9; see also Hearing, State Taxation, supra note 80, at 48 (testimony of James B. Zagel, Director of Revenue, State of Illinois).


110. The wage and tax rates of nations like Malaysia or Republic of Korea (South Korea) are far below those of the United States, so low that the shipping costs associated with moving goods across the Pacific Ocean when combined with the cost of labor and the producing nation's tax claims still allow the producer to realize a greater profit than on a good manufactured in the U.S. These difference would remain no matter what tax system is used. In order to increase exports, it is necessary that the FSC incentive, or one like it, be in place as a counter to the structural advantages found in foreign nations.

111. See supra notes 32–33 and accompanying text.
There are two basic assumptions underlying the proposed policy that uses a combination of a FSC-style export incentive and the unitary tax system. The first assumption is that business decision-makers are sensitive to changes in the tax code and will try to divert capital into operations that will produce the highest possible net return. The second is that the aggregate tax responsibility of the corporate community will increase over the next several years.

The first assumption is supported by the DISC experience, which provides evidence that manipulation of the tax code will in fact produce adjustments in investment decisions by business. Taxes are part of the cost of producing goods, and when the tax on a good is lowered, the producer will realize greater net profits. Simple economic theory dictates that investment capital will gravitate towards the sector of the economy that offers the highest return. It therefore seems fair to assume that business will tailor investment to respond to changes in the tax code.

As to the second assumption, while there may be no real prospect of significantly higher federal taxes, aggregate corporate tax bills may still be expected to increase as a result of higher state taxes.112 Higher taxes could create an effective disincentive to foreign investment by equalizing the after-tax return between domestic and foreign investment through the system of progressive taxation.113 Simply put, the greater the tax responsibility, the greater the propensity of corporations to use tax incentives.

IV. CONCLUSION

In order to increase export activity, it is necessary to increase the profits realized from exporting while decreasing the profits made by direct foreign investment. The most effective means to these ends, absent significant governmental intervention, lie in manipulation of the tax code. A new export policy should rely on the proposed Foreign Sales Corporation as an export tax incentive, and on the implementation by the state of the unitary tax as a disincentive to direct foreign investment. The FSC and the unitary tax system, the incentive and the disincentive, are most effective when used in concert. Adopting the FSC-unitary tax package will produce greater U.S. export activity, higher investment in the domestic economy, and more jobs for American workers.

112. See supra note 94.

113. By taxing large profits at a higher rate, the amount of net return on highly profitable foreign investments will be brought into a greater equality with domestic investment, due to the progressive nature of the income tax system. The more money made, the more lost to taxes.

Given the FSC incentive, the net return of domestic investment therefore, exceeds the net return of an equal foreign investment. Because the rational investor operates on the basis of net return, he will invest in the U.S. economy under conditions like those outlined above. See supra note 3 and accompanying text.