Collection: Baker, James A.: Files
Folder Title: Department of Commerce (1)
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FROM

THE SECRETARY OF COMMERCE

TO: Jim Baker COMMERCE

Dear Jim,

Attached is some factual material which supports the transfer to the Department of Commerce of the chairmanships for both the U.S.-China Joint Economic Commission and the U.S.-U.S.S.R. Commercial Commission.

Mac

April 11, 1981

FORM SEC-394 (3-13-72) USCOMM-DC 470-P72

APR 10 1981

UNITED STATES DEPARTMENT OF COMMERCE
International Trade Administration
Washington, D.C. 20230

File
Commerce

MEMORANDUM FOR LIONEL OLMER

SUBJECT: Transfer of Chairmanship of the U.S.-China Joint Economic Committee to Commerce

Pros:

-- It is consistent with the trade reorganization which consolidates trade functions in USTR and Commerce.

-- Other active communist country commission chairmanships rest with Commerce (Poland, Romania, and Hungary).

-- Commerce has greater resources (80 in the entire East-West Trade unit vs. 5 in Treasury).

-- Experience shows once the broad economic issues are resolved, as in the case of China, commission activities turn more to trade and specific commercial problems.

-- The business community fully supports the transfer.

Treasury argues:

-- the chairmanship should remain in Treasury for continuity reasons. In fact the commission has been in existence less than a year;

-- the JEC should be chaired by Treasury because it considers broad economic issues. In fact, broad economic issues can be discussed under our chairmanship in the same way these issues are discussed in other commissions under Commerce.

If it is decided to transfer the China chairmanship to Commerce, I recommend that the decision also be to transfer the chairmanship of the U.S.S.R. Commission even though that commission is inactive.

J. Mishell George
Acting Assistant Secretary
for Trade Development

3 Attachments

Honorable Donald Regan
Secretary of the Treasury
Washington, D.C. 20220

Dear Don,

I have reviewed the question of the chairmanship of the U.S.-U.S.S.R. Commercial Commission and U.S.-China Joint Economic Committee, including the exchange of correspondence between our predecessors.

It seems to me that it is entirely consistent with the recent trade reorganization which consolidated the responsibilities for trade matters in USTR and Commerce that the chairmanship of these commissions be transferred to Commerce. While both initially dealt with a wide range of economic matters, today they are increasingly concerned with the practical problems confronting American companies and other specific trade issues. Further, we would like to use the commissions more extensively for active discussions of major projects of interest to U.S. firms in order to represent better the American business community. There is also a variety of specific bilateral issues that impact adversely on American firms which should be discussed on a government-to-government basis. As the counterpart in such discussions would be the ministries of foreign trade in each country, it seems logical that the lead on our side would be taken by the agencies having the primary responsibilities for trade.

While the activities of the Soviet commission are dormant for the moment, the China committee is active. I would like to move as soon as possible to inform the Chinese and, at an appropriate time, the Soviets that the chairmanships have been transferred to the Secretary of Commerce. Such transfer would strengthen our hand in more effectively implementing our programs and in representing the interest of the American business community in these countries.

I have discussed this question with Bill Brock who is in full agreement that the chairmanship of both the China committee and the Soviet commission be transferred to Commerce.

Sincerely,

Secretary of Commerce

cc: Secretary Haig
Assistant to the President for
National Security Affairs Allen
United States Special Trade
Representative Brock

RDSeverance/EWT/OEWCA/mfs 377-2076 2/11/81 WANG No. 6043
cc: Secy, ExSec, US/ITA, DAS/EWT, RDSeverance, Chron

X

DECISION MEMORANDUM

Acting Under Secretary for International Trade

Prepared by: Christine L. Lucyk/ITA/EWT/OEWCA/PRC, 377-3583

Subject: Chairmanships of U.S.-China Joint Economic Committee and Joint U.S. - USSR Commercial Commission.

SUMMARY

This is to recommend that you seek Secretary of Treasury Regan's agreement to transfer the Chairmanships of the U.S.-China Joint Economic Committee (JEC) and the Joint U.S.-U.S.S.R. Commercial Commission to you. It is important that this issue be resolved early in the new Administration, when some flexibility exists as to agency roles, as well as those of individual Cabinet officers. We expect Treasury to move quickly to reinforce its leadership role in the two commissions shortly after the new Administration takes office.

The U.S. Chairmanships of these commissions, which are the principal bilateral bodies established to consider outstanding economic/commercial issues between the two governments, currently rest with Treasury primarily as a result of the initiative of former Secretary Blumenthal. We believe that the logic of the trade organization and the disposition of agency resources required to provide secretariat services, the nature of current U.S.-PRC issues, and the natural course of development of joint commission issues argue strongly for the transfer of the Chairmanship from Treasury to Commerce at this time.

8183

JMGeorge Ex Sec
AS/TD

Background

In an overall sense, the lead in east-west joint trade commissions over the last eight years has passed in part from Commerce to Treasury. In 1972, the Secretary of Commerce (then Peter Peterson) played a key role in the establishment of the joint trade commissions with the Soviet Union and Poland, and served as the first U.S. chairman of both. The chairmanships of the Romanian and Hungarian commissions which were established later were also vested in Commerce. In the case of the Soviet Commission, chairmanship of the U.S. side passed from Commerce to Treasury with Peterson's departure from Commerce and George Shultz's appointment as Secretary of Treasury. Chairmanship of this commission has remained with Treasury ever since.

The U.S. chairmanship of the U.S.-China Joint Economic Committee rests with the Secretary of Treasury primarily because of the initiative of former Secretary Blumenthal, who had a personal interest in China dating from his residence there. Blumenthal served as chairman of the interagency Policy Review Committee on China that developed U.S. positions on various issues. Because settlement of claims and assets was the first issue on the agenda, Blumenthal was the first U.S. cabinet member to visit China after the establishment of diplomatic relations in January 1979. In preparation for and during his February 1979 visit to China, Blumenthal laid the groundwork for the Committee.

The Committee held its first session under the chairmanship of Treasury Secretary Miller last September in Washington.

Effect of Trade Reorganization

With the trade reorganization, responsibility for trade matters was consolidated in USTR and Commerce. Chairmanship of the East-West Foreign Trade Board was removed from Treasury and the function vested with the Trade Policy Committee chaired by the USTR.

The Work of Commissions

Joint Commissions, with the exception of the Soviet Commission, cover the entire range of outstanding commercial issues (e.g., textiles, fisheries, maritime, aviation). In reality, many of these are dealt with outside the commission process through bilateral negotiations. No forum other than the commissions exists, however, for considering issues such as business facilitation, commercial and major project information, industrial cooperation and patent protection. These issues, for which Commerce has primary responsibility, increasingly dominate commission sessions once normalization of commercial relations with a given country is under way. In the Soviet, Polish, Romanian and Hungarian Commissions, such issues have played an ever larger role over time.

This is also occurring in the case of the U.S.-China Joint Economic Committee. With major issues leading to normalization of economic relations substantially resolved, future sessions of the JEC will focus on practical problems confronting American companies in the Chinese market, and other concrete trade problems. The majority of the emerging issues are of a commercial nature, and therefore, clearly within Commerce's area of interest. Furthermore, the Commerce-chaired Working Group on Business Facilitation and Major Projects has been the only one of three working groups under the JEC to have established an active work program between Committee sessions. Aside from the Working Group's initial meeting in September in Washington, it met again in China in November and we are planning for a third meeting in March or April in Washington.

In short, the strongest argument for having Commerce chair the JEC is that the bulk of its work is commercial.

We believe the tentative schedule for the next meeting of the full JEC, in China in September 1981, represents the ideal venue for your first trip there as Secretary, if you are Chairman.

Resources for Supporting Joint Commissions

Commerce is the only agency which has sufficient personnel to provide support for an active joint commission. We can bring to the effort the resources of the entire East-West Trade unit (about 90 people), including the staff of the USSR and China Divisions (13 professionals) and the joint commission secretariat. By contrast, Treasury's Office of East-West Economic Policy has only four professionals covering all of the communist countries. USTR's staff is even smaller. In the case of the Soviet commission chaired by Treasury, Commerce has provided the secretariat services and our country specialists contribute a large share of the substantive work.

Industry Contacts

We believe that, in addition to the official talks, joint commissions should be used to create opportunities for U.S. industry to meet with the visiting foreign trade officials. This can be done either through arranging visits for them around the U.S., as we did for Romanian Vice Premier Burtica, or by having the Secretary invite senior company executives to Washington, as we did during the last Polish commission meeting here. Arranging such meetings is properly a Commerce function which we can most effectively perform when the Secretary of Commerce chairs the joint commission.

Previous Understandings

Also relevant to the question of the chairmanships is the understanding we believe was reached by former Secretary Kreps with Secretary Miller just after the latter's appointment to Treasury. In response to Secretary Kreps' proposal that chairmanship of the Soviet and Chinese joint commissions be transferred to Commerce, Secretary Miller indicated that he had a personal interest in both countries but especially the Soviet Union. He did, however, offer to yield to Commerce chairmanship of one of these commissions. He implied that it would be the Chinese Committee by suggesting that an appropriate time to transfer chairmanship of the China JEC would be after the resolution of the key financial issues outstanding between the U.S. and the PRC. These are now substantially resolved.

Another effort last summer to resolve the issue of chairmanship in favor of Commerce was derailed by circumstances of timing of the first session of the China JEC. Since that time, there has been an exchange of letters (attached) on the subject between Secretary Klutznick and Secretary Miller. The matter was left with an agreement to refer it to the White House following the election. By discussing it early now with Secretary Regan, it may be possible to resolve the issue without taking it to the President.

Recommendation

That you approach Secretary Regan as soon as practical suggesting that you chair the U.S.-China Joint Economic Committee and the Joint U.S. - USSR Joint Commercial Commission..

Attachment

APPROVED: _____

DISAPPROVE: _____

cc: George Severance Laux/PRC
USSR Chron WANG NO. 5053F*

Document No. 000212 C

THE WHITE HOUSE
WASHINGTON

TREASURY

STAFFING MEMORANDUM

DATE: April 9, 1981 ACTION/CONCURRENCE/COMMENT DUE BY: --

SUBJECT: U.S. Chairmanship of the US-China Joint Economic Committee

	ACTION	FYI
VICE PRESIDENT	☐	☐
MEESE	☐	☐
BAKER	☐	☒
DEAVER	☐	☐
STOCKMAN	☐	☐
ALLEN	☐	☐
ANDERSON	☐	☐
BRADY	☐	☐
DOLE	☐	☐
FIELDING	☐	☐
FRIEDERSDORF	☐	☐
GARRICK	☐	☐
GERGEN	☐	☐
HARPER	☐	☐

	ACTION	FYI
JAMES	☐	☐
MURPHY	☐	☐
NOFZIGER	☐	☐
WEIDENBAUM	☐	☐
CANZERI	☐	☐
FULLER *(For Cabinet)*	☐	☐
HICKEY	☐	☐
HODSOLL	☐	☒
MC COY	☐	☐
WILLIAMSON	☐	☐
_____	☐	☐
_____	☐	☐
_____	☐	☐
_____	☐	☐

Remarks:

Richard G. Darman
Deputy Assistant to the President
and Staff Secretary
(x-2702)

THE WHITE HOUSE
WASHINGTON

CABINET ADMINISTRATION STAFFING MEMORANDUM

DATE: 4/8/81 NUMBER: 212CA DUE BY: COB, 4/10/81

SUBJECT: U.S. Chairmanship of the US-China Joint Economic Committee

	ACTION	FYI
ALL CABINET MEMBERS	☐	☐
Vice President	☐	☐
State	☐	☐
Treasury	☐	☐
Defense	☐	☐
Attorney General	☐	☐
Interior	☐	☐
Agriculture	☐	☐
Commerce	☐	☐
Labor	☐	☐
HHS	☐	☐
HUD	☐	☐
Transportation	☐	☐
Energy	☐	☐
Education	☐	☐
Counsellor	☑	☐
OMB	☐	☐
CIA	☐	☐
UN	☐	☐
USTR	☐	☐
_____	☐	☐
_____	☐	☐
_____	☐	☐
_____	☐	☐
_____	☐	☐

	ACTION	FYI
Baker	☐	☐
Deaver	☐	☐
Allen	☑	☐
Anderson	☑	☐
Garrick	☐	☐
Darman *(For WH Staffing)*	☑	☐
Gray	☐	☑
Beal	☐	☐
_____	☐	☐
_____	☐	☐
_____	☐	☐

Remarks: Please provide any views you have on this matter by Friday, April 10, 1981.

RETURN TO:

Craig L. Fuller
Deputy Assistant to the President
Director,
Office of Cabinet Administration
456-2823

THE SECRETARY OF THE TREASURY

WASHINGTON

April 2, 1981

MEMORANDUM FOR THE PRESIDENT

Subject: U.S. Chairmanship of the US-China Joint Economic Committee

In order to maintain continuity in the coordination of US-China economic policy, I request that you continue the designation of the Secretary of the Treasury as U.S. Chairman of the US-China Joint Economic Committee. My predecessors, Secretaries Blumenthal and Miller, have chaired this Committee since its inception, but a specific designation by the President has traditionally been required to continue this pattern.

The US-China Joint Economic Committee was established by President Carter and Vice Premier Deng Xiaoping in January 1979 to serve as the focal point for the coordination of US-China economic relations and to begin the task of economic normalization. This mechanism has successfully coordinated and executed U.S. economic policy towards China since the establishment of diplomatic relations on January 1, 1979. The Chinese attach great importance to the Joint Economic Committee whose work continues to be very active.

Suggestions have been made to transfer the American chairmanship of this Committee. I feel, however, that the structure of this body on the U.S. side encourages active participation by other departments and agencies so that the Committee can deal effectively with a wide range of economic issues. The Chinese co-chairman is a Vice Premier with broad economic policy responsibilities and would view a shift in U.S. leadership as a downgrading measure. If there are reasons for a change of leadership, the issue should first be considered by the Cabinet Council on Economic Affairs.

RECOMMENDATION: That you designate me in my capacity as Secretary of the Treasury to be the U.S. Chairman of the US-China Joint Economic Committee.

Donald T. Regan

Approve _____ Disapprove _____

Document No. 000213 CA

THE WHITE HOUSE
WASHINGTON

STAFFING MEMORANDUM

DATE: April 9, 1981 ACTION/CONCURRENCE/COMMENT DUE BY: --

SUBJECT: U.S. Chairmanship of the Joint US-USSR Commercial Commission

	ACTION	FYI
VICE PRESIDENT	☐	☐
MEESE	☐	☐
BAKER	☐	☒
DEAVER	☐	☐
STOCKMAN	☐	☐
ALLEN	☐	☐
ANDERSON	☐	☐
BRADY	☐	☐
DOLE	☐	☐
FIELDING	☐	☐
FRIEDERSDORF	☐	☐
GARRICK	☐	☐
GERGEN	☐	☐
HARPER	☐	☐

	ACTION	FYI
JAMES	☐	☐
MURPHY	☐	☐
NOFZIGER	☐	☐
WEIDENBAUM	☐	☐
CANZERI	☐	☐
FULLER *(For Cabinet)*	☐	☐
HICKEY	☐	☐
HODSOLL	☐	☒
MC COY	☐	☐
WILLIAMSON	☐	☐
_____	☐	☐
_____	☐	☐
_____	☐	☐
_____	☐	☐

Remarks:

Richard G. Darman
Deputy Assistant to the President
and Staff Secretary
(x-2702)

THE WHITE HOUSE
WASHINGTON

CABINET ADMINISTRATION STAFFING MEMORANDUM

DATE: April 8, 1981 NUMBER: 213CA DUE BY: COB, 4/10/81

SUBJECT: U.S. Chairmanship of the Joint US-USSR Commercial Commission

	ACTION	FYI
ALL CABINET MEMBERS	☐	☐
Vice President	☐	☐
State	☐	☐
Treasury	☐	☐
Defense	☐	☐
Attorney General	☐	☐
Interior	☐	☐
Agriculture	☐	☐
Commerce	☐	☐
Labor	☐	☐
HHS	☐	☐
HUD	☐	☐
Transportation	☐	☐
Energy	☐	☐
Education	☐	☐
Counsellor	☑	☐
OMB	☐	☐
CIA	☐	☐
UN	☐	☐
USTR	☐	☐
_____	☐	☐
_____	☐	☐
_____	☐	☐
_____	☐	☐
_____	☐	☐

	ACTION	FYI
Baker	☐	☐
Deaver	☐	☐
Allen	☑	☐
Anderson	☑	☐
Garrick	☐	☐
Darman *(For WH Staffing)*	☑	☐
Gray	☐	☑
Beal	☐	☐
_____	☐	☐
_____	☐	☐
_____	☐	☐

Remarks: Please provide any views you have on this matter by Friday, April 10, 1981.

RETURN TO:

Craig L. Fuller
Deputy Assistant to the President
Director,
Office of Cabinet Administration
456-2823

THE SECRETARY OF THE TREASURY

WASHINGTON

April 2, 1981

MEMORANDUM FOR THE PRESIDENT

Subject: U.S. Chairmanship of the Joint US-USSR Commercial Commission

I request that you continue the designation of the Secretary of the Treasury as U.S. Chairman of the Joint US-USSR Commercial Commission. My predecessors, Secretaries Shultz, Simon, Blumenthal and Miller, have chaired this Commission since its inception, but a specific designation by the President has traditionally been required to continue this pattern.

The Joint US-USSR Commercial Commission was created during President Nixon's visit to Moscow in 1972 in an effort to develop commercial and economic relations between our two countries. The last scheduled meeting of this body was cancelled by President Carter because of the Soviet invasion of Afghanistan. Since then the Commission's work has been halted and will remain inactive until our relations improve. Before the Commission is reactivated, there would, of course, have to be interagency discussion of its future role.

Even though the Commission is dormant, I feel it is useful to maintain this forum for economic dialogue and to have an American chairman in place. There is no reason to publicize the designation of a new U.S. chairman which has occurred routinely with the change of Administrations and Treasury leadership.

There has been a suggestion to have the American chairmanship of the body transferred to another department. I believe, however, that the structure permits the active participation of other departments and agencies, and I see no reason to change it. If a leadership transfer is to be made, this should first be considered in the Cabinet Council on Economic Affairs.

TED STEVENS
ALASKA

United States Senate

OFFICE OF
THE ASSISTANT MAJORITY LEADER
WASHINGTON, D.C. 20510

May 7, 1981

Mr. Francis S. N. Hodsoll
Deputy Assistant to the President
and Deputy to the Chief of Staff
First floor, West Wing
The White House
Washington, D.C. 20500

Dear Frank:

Your efforts to secure the recent agreement between the National Oceanic and Atmospheric Administration and the Alaska Eskimo Railing Commissioner are greatly appreciated.

I am aware of the time and effort that your office extended towards the resolution of this problem and delighted with the outcome. Termination of the Grand Jury investigation several days ago demonstrates the value of this agreement.

This agreement represents the first step forward by the United States Government towards our ultimate goal of permanent self management before the Eskimo people. It is the very embodyment of the President's theme of government trusting the people and I commend you for your help.

With best wishes,

Cordially,

TED STEVENS
United States Senator

File
Trade

Submission on Behalf of
Cargill Incorporated

Comments and Recommendations regarding Needed Changes in United States Taxation of Foreign Source Income in Order to Restore the Competitive Position of United States Owned Firms Engaged in International Trading of Agricultural Commodities

January 1981

Paul H. DeLaney, Jr.
Lord, Day & Lord
One Lafayette Centre
1120 Twentieth Street, N.W
Washington, D.C. 20036
(202)785-1766

Legislative History and Reasons for Agricultural Commodities Exception

The amendment would provide an exception to the Subpart F rules for international sales of agricultural commodities.

The committee recognizes the importance of an expanded agricultural commodities exception. The committee concludes that without this exception the competitive position of United States owned firms participating in international agricultural commodities trade would be undermined with the result that this important business could be transferred to foreign owned firms beyond United States tax jurisdiction and control and that this would be contrary to important United States national and international interests.

Based on its prior decisions and recent international tax and trade developments, the committee is aware that these sales are highly competitive and that taxing the undistributed profits of United States owned international trading companies on these sales places such United States owned firms at a substantial competitive disadvantage vis-a-vis their foreign counterparts. Accordingly, the committee believes it is appropriate to permit defferal for this category of income until such profits are repatriated to the United States.

The committee's decision provides that income derived from international sales of agricultural commodities will not be treated as foreign base company sales income. The committee believes that this rule will be easier for the Internal Revenue Service to administer than the rule under present law.

Agricultural commodities are defined to include livestock, fruits, vegetables, eggs, oils, fish, poultry, grains, timber, oilseeds, and any other crops. Also included are products derived from the above-mentioned commodities, so long as: } v. broad.

1. the product is dealt in on an organized commodity exchange; or

2. the product is fungible and handled in bulk, bag or drum; or

3. not more than 50 percent of the fair market value of the product is attributable to manufacturing or processing.

Under this definition, semi-processed commodities, such as sugar, molasses, hides, lumber, soybean meal and soybean oil, are considered agricultural commodities. Hides, for example, constitute a product derived from livestock and are covered under the fungibility and percentage tests of the exception. Hides are sold by the pound and handled in bulk by carload and, therefore, are fungible within the meaning of the exception.

Furthermore, hides are presently sold for betweeen $30 and $50. The slaughtering function is not included in the term processing and, therefore, slaughtering cost is not included in the cost calculation under the exception. Hides are subject to various preserving processes which cost between $3.00 and $6.00 per hide. This amounts to substantially less than 50 percent of the fair market value of the hide and is well within the percentage test under the exception.

The definition of agricultural commodities also includes timber and semi-processed products derived from timber such as lumber and wood pulp. Additionally, a more completely processed derivative of timber, such as plywood would also be classified as an agricultural commodity under the above definition.

Lumber and wood pulp are handled in bulk and are fungible goods. Accordingly, these products would be deemed to be agricultural commodities under the fungibility test of the exception. Moreover, lumber, including plywood and wood pulp, would be considered an agricultural commodity under the percentage test of the exception. For example, Douglas fir, graded standard or better, sells for a net FOB price of approximately $200 per thousand board feet. The handling, grading, harvesting and storage costs attributable to lumber would not be considered part of the processing of the raw material and, accordingly, these expenses would not be included in the cost calculations under the exception. Lumber is subject to various milling and drying processes which generally attribute less than $100 to the price of the product. In this regard, such processing costs are less than 50 percent of the fair market value of the lumber and would qualify under the percentage test of the exception.

The percentage exception test would also apply to plywood. Standard one-half inch DCX plywood sells net FOB for approximately $220 per thousand square feet. In the manufacture of plywood, certain costs attributable to grading, storing and handling are incurred. These costs are not included as processing costs under the exception and, therefore, are not included in the cost calculation under the exception. The production of plywood does entail other manufacturing costs of approximately $100 per thousand square feet of plywood produced. These costs are less than 50 percent of the fair market value of the plywood and, accordingly, plywood, like lumber, falls within the percentage test of the exception.

Soybean meal and soybean oil, the two principal products produced from soybeans, are considered agricultural commodities. Both are traded on the Chicago Board of Trade (an organized commodity exchange) and are extensively traded in international commerce. Both commodities are fungible and commonly handled in bulk lots although smaller lots are shipped to markets unable to handle large bulk shipments

Very little value is added to soybeans in processing. A metric ton of soybeans (36.74 bushels) is currently valued at about $257. Processing of that amount of soybeans will yield approximately 1,750 pounds of meal and 400 pounds of soybean oil. At current prices, the 1,750 pounds of meal is worth about $184.20 and the 400 pounds of soybean oil is worth $94.60 for a total value of $278.80. The only profit margin for the processor is the small amount of profit gained in crushing plus the value of about 70 pounds of soybean hulls which are a byproduct of crushing.

Furthermore, soybean flour, soybean grits, and textured soybean protein would also be considered agricultural commodities, as both soybean flour and soybean grits are shipped in bulk and not more than 50 percent of value would be attributable to processing, while it is expected that soybean protein will, in all likelihood, be shipped in bulk lots in the future as its use abroad increases.

The committee believes that this change will also make it easier for the Internal Revenue Service to administer the Subpart F agricultural commodities exception.

The following transactional examples further demonstrate the reasons and need for this exception and set forth situations where foreign owned international trading companies are more competitive in world markets than United States owned international trading companies.

1. A Bermudian trading corporation owned by French investors is engaged in the business of buying corn grown in France, the United States Argentina, or other countries of origin and exporting the corn to various world markets. Ther Bermudian corporation buys corn from a related corporation which is in the trade or business of locating and purchasing corn in the country of origin. In this situation, where the Bermudian trading company is owned by French nationals, profits earned by the Bermudian corporation would not be subject to taxation in either Bermuda or France at the time of sale. On the other hand, if the Bermudian corporation were owned by United States interests, profits earned on the sale by the Bermudian corporation would be subject to immediate United States taxation under Subpart F (the undistributed profits of the Bermudian trading corporation would be subject to current United States taxation prior to repatriation).

2. A Panamanian trading corporation owned by a Brazilian corporation is in the business of buying soybeans grown in Brazil, the United States or other countries of origin and exporting the soybeans to Italy. The Panamanian corporation buys the soybeans from a related corporation in the country of origin and markets the soybeans in Italy. In this situation, where the Panamanian trading company is owned by a Brazilian parent corporation, profits earned by the Panamanian corporation would not be subject to taxation in either Panama or Brazil at the time of sale. On the other hand, if the Panamanian corporation were owned by a United States parent corporation, profits earned on the sale by the Panamanian corporation would be subject to immediate United States taxation under Subpart F (the undistributed profits of the Panamanian trading corporation would be subject to current United States taxation prior to repatriation).

3. A Netherlands Antilles trading corporation owned by a Dutch corporation is in the business of buying wheat grown in France, potatoes grown in the Netherlands, and corn grown in the United States and merchandising such agricultural commodities to various world markets. The Netherlands Antilles corporation buys the wheat, potatoes and corn from related corporations in the countries of origin. In this situation, where the Netherlands Antilles trading company is owned by a Dutch parent corporation, profits of the trading corporation would be subject to only limited taxation in the Netherlands Antilles when earned and would not be subject to any taxation when repatriated to the Dutch parent in the Netherlands. On the other hand, if the Netherlands Antilles trading corporation were owned by a United States parent corporation, profits earned by the trading corporation would be subject to immediate United States taxation under Subpart F (the undistributed profits of the Dutch-owned trading corporation would be subject to current United States taxation prior to repatriation).

In the examples noted above, the ability of foreign owned international trading entities to defer taxation (or in some cases essentially avoid taxation altogether) on trading company profits undermines the competitiveness of United States owned international trading companies. This, in turn, adversely affects the ability of the United States owned international trading companies to promote increased exports of United States-produced agricultural commodities.

Proposed Amendment to Expand Agricultural Commodities Exception

United States Internal Revenue Code Section 954(d)

The last sentence of Section 954(d)(1) would be amended to read as follows:

For purposes of this subsection personal property does not include agricultural commodities.

Section 954(d) would also be amended by adding the following paragraph after Section 954(d)(3):

(4) AGRICULTURAL COMMODITIES DEFINED. -- For purposes of this subsection, the term "agricultural commodities" means --

(A) livestock, fruits, vegetables, eggs, milk, fish, poultry, grains, timber, oilseeds, and any other crops; and,

(B) products derived from commodities listed in subparagraph (A) provided --

(1) the product is dealt in on an organized commodity exchange; or

(2) the product is fungible and handled in bulk, bag or drum; or

(3) not more than 50 percent of the fair market value of the product is attributable to manufacturing or processing.

For purposes of this subsection the term "processing" shall not include handling, packing, packaging, grading, storing, transporting, slaughtering, and harvesting.

Revenue Considerations Regarding Proposed Exception for International Agricultural Commodities Trading Income

If the United States Congress adopts the proposed exception for international agricultural commodities trading income by excluding such income from current taxation under the provisions of Subpart F of the United States Internal Revenue Code, the following analysis suggests that potential United States revenue losses would be limited if any.

The revenue estimates set forth below provided by the staff of the Joint Committee on Taxation ("Joint Committee") regarding the agricultural commodities exception as adopted by the House Ways and Means Committee under the provisions of the Tax Reform Act of 1975 support the proposition that potential revenue losses would be very limited: 1/

"Table 3.--Tax Reform--Effect on Calendar Year Tax By Bill Title and Section and Type of Taxpayer

[In millions of dollars]

Section	1976	1977	1978	1979	1980	1981
* * *						
Title X--Foreign Income Provisions						
* * *						
1025 Limitation on definition of foreign base company sales income in the case of certain agricultural products	-10	-10	-10	-10	-10	-10"

1/ See Report of the Committee on Ways and Means on H.R. 10612, the Tax Reform Act of 1975, 94th Cong., 1st Sess., p. 20, November 12, 1975. See also Summary of the Major Provisions of H.R. 10612, the Tax Reform Act of 1975 as Passed by the House of Representatives on December 4, 1975, 94th Cong., 1st Sess., p. 50, December 8, 1975.

Similarly, the revenue estimates of the Joint Committee under the version of the agricultural commodities exception based on the third market trade approach as adopted by the Senate Finance Committee pursuant to the provisions of the Tax Reform Act of 1976 suggests that potential revenue losses would be very limited. 2/

"Table 1--Tax Reform Under the Committee Amendment--
Effect on Fiscal Year Tax Receipts

[In millions of dollars]

	Transition quarter	1977	1978	1979	1980	1981
* * *						
Foreign Tax Provisions						
* * *						
Limitation on definition of foreign base company sales income in the case of certain agricultural products	-5	-17	-15	-15	-15	-15"

It should be recognized that the revenue estimates of the Joint Committee staff are based on the assumption that United States based international trading firms would continue to participate in the subject international agricultural commodities trade and would derive the subject income from such trade. Accordingly, it is suggested that even the Joint Committee staff's very limited estimated revenue losses overstate the potential for any losses to the United States federal government as it is extremely doubtful that United States based international trading firms would generate such income where such firms continue to operate at a competitive tax disadvantage vis-a-vis their foreign based competitors which are not subject to United States tax jurisdiction and control, i.e. this trade and the potential income derived from it would move beyond United States tax jurisdiction and control in the absence of the agricultural commodities exception which would place United States based firms on a substantially equivalent tax footing with their foreign based competitors. Furthermore, it is suggested that adoption of the agricultural commodities exception would not involve any United States revenue losses, but to the country would result in revenue gains when such profits are repatriated to the United States in the form of dividends which would be subject to United States federal income taxes.

2/ See the Report of the Committee on Finance on the Tax Reform Act of 1976, 94th Cong., 2nd Sess., p. 25, June 10, 1976.

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Comments and Recommendations regarding Needed Changes in United States Taxation of Foreign Source Income in Order to Restore the Competitive Position of United States Owned Firms Engaged in International Trading of Agricultural Commodities

INTRODUCTION

The purpose of this memorandum is to recommend a needed change in United States taxation of foreign source income in the context of the Tokyo Round of multilateral trade negotiations ("MTN") and related international proceedings renewed United States congressional consideration of international tax and trade issues in the 97th Congress to restore the competitive position of United States owned firms engaged in international trading of agricultural commodities. The proposed change has important international tax and trade implications, and recent developments suggest the timeliness of action on this matter early in the 97th Congress.

In accordance with recent international tax and trade developments, including the MTN, with particular reference to the Subsidies and Countervailing Duty Code ("Subsidies Code"), the November 1976 Panel Decisions under the auspices of the General Agreement on Tariffs and Trade ("GATT") on certain tax practices of the United States, France, Belgium and the Netherlands ("GATT Panel Decisions"), and various proceedings and deliberations of the House Ways and Means Committee and the Senate Finance Committee, it is urged that the United States Congress, and more specifically the Members of the House Ways and Means Committee and the Senate Finance Committee, adopt a necessary change in United States federal income tax law to place United States owned firms which trade in international agricultural commodities on a substantially equivalent tax footing with their foreign owned competitors.

Subpart F was added to the United States Internal Revenue Code under the provisions of the Revenue Act of 1962. Its effect is to tax on a current basis the undistributed earnings and profits of United States owned foreign based trading companies (controlled foreign corporations). Before 1962 such income was taxed like income of other foreign corporations, only when it was repatriated to the United States. The effect of Subpart F has

been to discourage the formation and operation of United States owned foreign based trading companies by placing them at a significant disadvantage in their competition with foreign owned trading companies. Generally, other major trading nations do not tax such income of international trading companies prior to repatriation, and in point of fact, many countries do not tax this income at all. Instead, recognizing the value of such trading companies in expanding domestic exports, most nations have actively encouraged and supported the formation and growth of such companies. Japanese and European international trading companies have been especially successful in exploiting opportunities in world markets.

As a consequence of the major differences in the historical evolution of United States tax law and the tax laws of other major trading nations of the world, it is not surprising that there are generally no United States counterparts to the Japanese trading companies or other foreign based international trading companies. Furthermore, foreign based international trading companies have played a major role in expanding the trade of other nations which compete with the United States. Nations such as Japan, West Germany, and the Netherlands have placed the highest priority on international trade considerations and have provided substantial incentives to trading firms located within their borders. If the United States is to be competitive in international trading markets, it must also develop policies and provide incentives directed towards encouraging international trading activity by United States owned firms.

It is understandable that international trade considerations played so limited a part in the discussions and considerations which led to Subpart F in 1962. At that time, the United States was still the dominant world economic power, with large year-to-year surpluses on trade account. Indeed, the Kennedy Administration in assessing the impact of eliminating deferral concluded that United States owned firms established abroad could continue to compete with their foreign owned competitors as a consequence of the superior position of such United States owned firms with respect to preferential access to world capital markets, advanced technical know-how, energy, resourcefulness, and various other advantages; it was assumed that based on these considerations, such United States firms would retain their position in world markets, even absent deferral.

These circumstances have changed in recent years. The United States position in world trade has deteriorated as other nations have emerged as strong competitors. Consistent United States surpluses have given way to large deficits. There is a growing consensus that steps must now be taken to increase United States competitiveness in all international markets.

Notwithstanding the enactment of Subpart F in 1962, several United States based international trading companies were able to continue operations under significant exceptions which the Congress included as a part of Subpart F. These firms have played a major role in the rapid expansion of United States farm exports in the past 15 years.

Further amendments to the Internal Revenue Code in 1975 have eliminated or drastically reduced the scope of these exceptions. The effect has been to undermine the competitive position of United States international agricultural trading firms. These firms cannot absorb the tax disadvantages imposed by amended Subpart F as they possess no unique advantages such as established brand franchsies or product superiority. The products which these United States international trading firms offer, raw or semi-processed agricultural commodities, are the same products offered by their foreign owned competitors; these products are acquired from the same sources and sold to the same ultimate customers. Traditionally low margins in this commerce offer limited, if any, opportunity for absorbing significant cost disadvantages.

United States owned international trading firms faced with this reality have two choices: they can slowly surrender their business to foreign owned trading firms not subject to such United States taxes, or they can share (or give up) control of their foreign based international trading operations with foreign interests not subject to United States tax jurisdiction and control. In either event, the United States loses two ways. First, the United States is surrendering important advantages in world trade. While foreign based trading companies typically trade in farm commodities from all origins, United States owned firms gain most from sales of United States commodities because such firms maintain large capital investments in facilities which can be used only in originating commodities produced in the United States. Active participation by United States firms in all world markets assures that in any negotiation involving agricultural products, United States interests in selling are actively represented. Sharing of ownership and control of these firms with foreign interests (or surrendering control to such interests) will dilute the primary interest of United States firms in selling United States commodities in the world resellers market. Second, to the extent this activity passes beyond United States tax jurisdiction and control, the United States loses the opportunity to tax the income derived from this international commerce when such income is subsequently repatriated to the United States.

More recently, based in large part on these changes in economic circumstances, the United States Congress has become increasingly concerned about the declining position of United States firms in international trading markets, and the Congress has indicated a willingness to proceed with necessary changes in United States law including United States tax law, to enable United States firms to be more competitive in world markets.

The substantial emphasis directed in international trading activities by most of the major trading nations is clearly reflected in the tax systems adopted by such countries which are designed to stimulate their exports and international trading activities. More particularly, the territorial system of taxation utilized by most of these countries clearly places United States based firms at a competitive tax disadvantage in competing for world markets.

Although Congress has recognized this problem and the importance of providing necessary incentives to United States firms, it has yet to enact changes in United States tax law needed to accomplish this objective. The proposed exception to Subpart F for income from international trading in agricultural commodities is designed specifically to encourage further expansion of agricultural trade by placing United States owned international trading companies on more equal tax footing with their foreign owned competitors which are beyond United States tax jurisdiction.

Several recent events suggest the importance and timeliness of Congressional action on this issue early in the 97th Congress:

1. The provisions of the Trade Act of 1974 and various statements by Congressional Committees recognize that taxes play an important role in trade.

2. Both the House Ways and Means Committee and the Senate Finance Committee have recognized that application of Subpart F to United States owned firms engaged in world agriculture trade reduces their competitiveness and their ability to market United States agricultural products abroad effectively;

3. Despite the decisions by GATT panels that the tax practices of certain European countires designed to stimulate exports and international trading activities violate GATT obligations, the United States has not been able to secure changes in these practices;

4. United States trade negotiators in the Tokyo round of multilateral trade negotiations have been unsuccessful in obtaining concessions or agreement from other major trading nations regarding the impact taxes on international trade under the provisions of the Subsidies Countervailing Duty Code;

5. United States negotiationg efforts directed towards obtaining international rules to assure tax equity and fairness are strengthened by placing United States based companies on a similar tax footing with their foreign owned competitors. It is clear that so long as others enjoy advantages in world trade under present arrangements they have little incentive to enter into negotiations designed to create equality in the tax treatment of firms involved in international trade.

This memorandum proposes that the United States Congress amend the provisions of Subpart F of the Internal Revenue Code to exclude from current taxation undistributed income derived from international sales of agricultural commodities (such income would not be taxed until repatriated to the United States). This would expand the concept already accepted by the Congress in the present limited agricultural commodities exception under present law. In this regard, both the House Ways and Means Committee and the Senate Finance Committee have previously considered, voted on, and reported out favorably an expanded version of this agriculture commodities exception.

Adoption of this amendment would assure that United States owned firms could compete more effectively in international trading markets for sales agricultural commodities and would also provide needed leverage for meaningful international discussions designed to achieve equity in the tax treatment of all international trading enterprises.

DISCUSSION

United States Taxation of Foreign Source Income

Tax Jurisdiction and Taxation of Foreign Source Income

A particular nation may tax the worldwide income of its nationals, restrict the scope of its tax jurisdiction to a territorial basis (tax only domestic source income), or provide for other means of limiting the taxation of foreign source income.

In response to a United States Congressional inquiry in March 1973, a study was prepared under the auspices of the Council on International Economic Policy ("CIEP") regarding tax treatment by other nations of their own multinational firms (taxation of foreign source income). 1/

This study summarized the basic rules concerning taxation of foreign source income of the following countries: Belgium, Brazil, Canada, Denmark, France, Federal Republic of Germany, Ireland, Italy, Japan, the Netherlands, Norway, Switzerland, and the United Kingdom.

Although it is difficult to generalize concerning the effect of foreign tax systems, despite varied approaches to taxation (worldwide, territorial, and varied forms of exemptions and credits), it is apparent that most major trading nations do not tax currently the undistributed profits of a foreign subsidiary controlled by local residents. The United States departure from the general scheme of international taxation practiced by other nations places United States owned companies engaged in international operations at a severe competitive disadvantage.

1/ See information submitted for the record by the Council on International Economic Policy to the Subcommittee on International Trade, Senate Finance Committee, Hearings on Multinational Enterprises, February 26 through March 6, 1973.

United States Tax Jurisdiction

United States federal tax jurisdiction is based on two general principles: 2/

1. Nationality, under which the United States taxes worldwide income of "United States persons"; 3/ and

2. Source of income, under which the United States taxes "United States source income" of United States persons and "foreign persons", including "nonresident aliens" and "foreign corporations" (in limited circumstances, the United States taxes "foreign source income" of foreign persons "effectively connected with a United States trade or business").

The term "United States person" includes United States domestic corporations. 4/

United States Taxation of United States Corporations and Foreign Corporations

The modern United States corporate income tax dates from 1909. At that time, domestic corporations were taxed on income from all sources and foreign corporations on income from business transacted and capital invested within the United States. This jurisdictional pattern remained substantially unchanged until 1962.

The impact of tax on the foreign source income of United States persons was softened somewhat in 1918 with the adoption of a foreign tax credit. Previously, foreign taxes had merely been deductable, like state and local taxes. The credit can apply to both the earnings and profits of foreign subsidiary corporations and foreign branches. Only payments treated as income taxes, or "in lieu of income taxes", qualify for the credit. 5/

2/ See Internal Revenue Code of 1954, as amended, Title 26 U.S.C. §§1 and 11(a) (sometimes hereinafter referred to as the "I.R.C.") which set forth very broad jurisdictional rules, imposing tax on the taxable income of "every individual" and "every corporation," respectively.

3/ The term "United States person" and other relevant terms pertaining to United States tax jurisdiction are defined and discussed subsequently in this memorandum.

4/ I.R.C. § 7701(a)(30) defines "United States person" to include citizens, residents, domestic partnerships, domestic corporations, and domestic estates and trusts.

5/ See I.R.C. §§ 901-906.

In broad terms, a corporation is treated as a United States domestic corporation if it is incorporated in any of the states of the United States or the District of Columbia and is treated as a foreign corporation if it derives its charter from a foreign government.

Foreign source income earned by a foreign corporation controlled by United States persons is generally exempt from United States taxation until distributed to shareholders who are United States persons. 6/

A corporation receiving a dividend from a controlled United States domestic corporation is generally entitled to exclude most of that dividend from its taxable income on the theory that it has already been subject to tax. 7/ Dividends from a foreign corporation are not entitled to this exclusion. Likewise, dividends from a foreign corporation are not entitled to the $100 exclusion of dividends received by individuals. 8/ Therefore, United States shareholders of foreign corporations are generally taxed fully on dividends received from foreign corporations.

A United States corporation which in any taxable year owns at least 10 percent of the voting stock of a foreign corporation from which it received dividends is entitled to a foreign tax credit for income taxes paid by that foreign corporation. 9/

Current Taxation of Undistributed Earnings and Profits of Foreign Corporations

Although United States shareholders (United States persons) of foreign corporations are generally not subject to United States tax on the income of such foreign corporations unless, and until, such income is repatriated to the United States in the form of dividends (or remittances in the nature of a dividend), United States shareholders of two categories of foreign corporations are effectively subject to current United States taxation on certain types of undistributed income:

1. "Foreign personal holding companies"; and

2. "Controlled foreign corporations".

6/ See I.R.C. §§1, 11, 861-864, 881-883, and 1201.

7/ See I.R.C. §243.

8/ See I.R.C. §116.

9/ See I.R.C. §902.

United States Taxation of Controlled
Foreign Corporations under Subpart F

In the Revenue Act of 1962, 10/ the United States Congress added Subpart F to the Internal Revenue Code in an effort to deal with the problem of tax haven operations. 11/ Under Subpart F, United States shareholders of controlled foreign corporations ("CFCs") are subject to current United States income taxation on certain forms of undistributed tainted income (tax haven or Subpart F income):

1. Subpart F income, including foreign base company income and income derived from insurance of United States risks;

2. Previously untaxed Subpart F income withdrawn from investment in less developed countries; and

3. Any increase in investment in United States property to the extent it would be taxable as a dividend if distributed to United States shareholders.

It should be understood that Subpart F taxes United States shareholders not on their own income, but on the income of CFCs in which they own an interest. Subpart F jurisdiction is predicated on United States citizenship or residence, rather than source of income.

10/ See Revenue Act of 1962, P.L. 87-834, H.R. 10650, 87th Cong. 2d Sess., 76 Stat. 960, October 16, 1962.

11/ See I.R.C. § 951(a)(1).

Recent Legislative History of United States Taxation of Foreign Source Income Including International Trading Income

Tax Reduction Act of 1975

In March 1975, the President of the United States signed the Tax Reduction Act of 1975 (sometimes hereinafter referred to as the "TRA"), thus providing for several significant modifications concerning United States taxation of foreign source income: 12/

1. The so-called "30-70" "safe haven" or "shielding" rules which had applied to CFCs where foreign based company income constitutes less than 30 percent of gross income were amended to reduce the relevant threshold test to less than 10 percent;

2. The minimum distribution exception to current taxation of Subpart F income was terminated;

3. The exclusion for certain foreign personal holding company income reinvested in less developed countries was eliminated; and,

4. The exception for foreign base company shipping income was limited to income reinvested in shipping operations.

The relevant House bill had contained no provisions amending United States rules for CFCs and their United States shareholders. 13/ Nor did the Senate Finance Committee recommend changes in this area of United States tax law. 14/ Nevertheless, pursuant to amendments voted on the floor of the Senate, it was provided that United States persons holding a one percent or greater interest in a foreign corporation would be taxed currently on their proportionate share of the income from such a corporation in cases where more than 50 percent of the stock of the corporation was controlled by United States persons.

12/ See §602, Tax Reduction Act of 1975, P.L. 94-12, H.R. 2166, 94th Cong. 1st Sess., 89 Stat. 58, March 29, 1975.

13/ See Tax Reduction Act of 1975, H.R. 2166, 94th Cong. 1st Sess., March 17, 1975.

14/ See Report of the Senate Finance Committee accompanying H.R. 2166, Sen. Rep. No. 94-36, 94th Cong. 1st Sess., March 17, 1975.

The House and Senate conferees adopted a compromise which expanded on the Subpart F approach to tax specific categories of income on a current basis: 15/

> "The conference substitute provides for a number of specific measures which substantially expand the extent to which foreign subsidiaries of U.S. corporations are subject to current U.S. taxation on tax haven types of income under the so-called Subpart F rules of the Code.
>
> * * *
>
> "The conference substitute repeals the minimum distribution exception to the Subpart F rules which, under present law, permits a deferral of U.S. taxation on tax haven types of income in cases where the foreign corporation (or various combinations of foreign-related corporations) distributed certain minimum dividends to their U.S. shareholders. The effect of repealing this exception is to tax currently all income of foreign subsidiaries of U.S. corporations which is deemed to be tax haven income under the existing so-called Subpart F rules of the Code. An exception to this provision was made for agricultural commodities not produced in commercially marketable quantities in the United States. Under the exception, these commodities grown (or raised) abroad are to be excluded from foreign base company sales income." [Emphasis supplied.]

It was noted at the time of conference, that unless an agricultural commodities exception was adopted, the competitive position of the United States owned firms participating in international agricultural commodities trade would be undermined with the result that this important business would be transferred to foreign owned firms beyond United States tax jurisdiction and control and that this would be contrary to important United States national and international interests.

Following enactment of the Tax Reduction Act of 1975, it was recognized that certain ambiguity was inherent in language chosen to create the new agricultural commodities exception.

15/ See Conference Report accompanying H.R. 2166, p. 70, Rep. No. 94-120, 94th Cong. 1st Sess., March 26, 1975.

Tax Reform Act of 1975

The issue of the agricultural exception was raised again during proceedings of the House Ways and Means Committee in late 1975. 16/ The concensus was that a technical amendment was probably needed to clarify the meaning of the Tax Reduction Act of 1975 provision. The language incorporated in the 1975 House Bill to accomplish this purpose, provided: 17/

> "(a) IN GENERAL.-The last sentence of paragraph (1) of section 954(d) (relating to definition of foreign based company sales income) is amended to read as follows:
>
> > "For purposes of this subsection, personal property does not include agricultural commodities which are significantly different in grade or type from and are determined by Secretary of the Treasury after consultation with the Secretary of Agriculture not to be readily substitutable for (taking into account consumer preferences) agricultural products grown in the United States in commercially marketable quantities.'"

The House Ways and Means Committee advanced the following agruments in support of revising the language of the Tax Reduction Act of 1975: 18/

> ". . . One of the categories of tax haven income subject to current taxation under the Subpart F provisions of the code is base company sales income. The Tax Reduction Act of 1975 contained an amendment

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16/ See Committee Print prepared for the use of the Committee on Ways and Means by the staff of the Joint Committee on Internal Revenue Taxation concerning U.S. Taxation of Foreign Source Income, p. 8, September 27, 1975.

17/ See Section 1025 of the Tax Reform Act of 1975 (concerning limitation on definition of foreign base company sales income in the case of certain agricultural products), H.R. 10612, p. 211 and 212, Rep. No. 94-658, 94th Cong., 1st Sess., November 12, 1975.

18/ See Report of the House Ways and Means Committee accompanying H.R. 10612, p. 221, Rep. No. 94-658, 94th Cong., 1st Sess., November 12, 1975.

> which provides that base company sales income does not include the sale of agricultural commodities which are not grown in the United States in commercially marketable quantities. It has come to your committee's attention that questions have been raised as to the extent that this exclusion applies to agricultural products which are of a different grade or variety from the same product grown in the United States. Your committee believes that sales of foreign-grown agricultural products which are not readily substitutable for U.S.-grown agricultural products should not be included within the definition of foreign base company sales income in the case of sales made to third countries. Your committee is aware that these sales are highly competitive and that if the profits on these sales were subject to U.S. tax on a current basis, U.S.-controlled foreign companies would have difficulty competing with foreign-controlled companies. Accordingly, your committee believes it is appropriate to permit this category of income to retain the tax advantages of deferral until the profits are repatriated to the United States." [Emphasis supplied.]

Notwithstanding the clear concern of the House Ways and Means Committee that the United States owned companies be given a continuing opportunity to compete for this important business, it was recognized that substantial complexity might be involved in interpreting this language as a consequence of inherently difficult constructions.

Tax Reform Act of 1976

In early December 1975, the full House passed the Tax Reform Act of 1975, H.R. 10612, and referred the bill to the Senate. Because of time constraints and other considerations, the Senate Finance Committee directed its immediate attention to the tax reduction provisions of the House bill. The tax reform provisions of the 1975 House bill, including the provisions modifying the agricultural exception to Subpart F, were not considered by the Senate Finance Committee in 1975.

The Senate Finance Committee began hearings in March 1976 on major tax revision proposals and extension of expiring tax cut provisions. The Committee reported out a bill for consideration of the full Senate in June 1976. 19/

19/ See report of the Committee on Finance, United States Senate, accompanying H.R. 10612, Rept. No. 94-938, 94th Cong., 2nd Sess., June 10, 1976.

The Senate Finance Committee initially adopted an agricultural commodities exception based on the third market country approach: 20/

"SEC. 1025. LIMITATION ON DEFINITION OF FOREIGN BASE COMPANY SALES INCOME IN THE CASE OF CERTAIN AGRICULTURAL PRODUCTS.

(a) IN GENERAL.--The last sentence of paragraph (10) of section 954(d) (relating to definition of foreign base company sales income) is amended to read as follows: 'For purposes of this subsection, personal property does not include agricultural commodities grown or produced outside the United States if sold for use, consumption or disposition outside the United States.'"

This approach provided a clear and easily administered standard which would enable United States owned firms to compete for the important third country trade without significant doubts about the tax consequences under United States laws.

The following reasons for adopting this approach were noted in the Senate Finance Committee report. 21/

"Certain agricultural products

Reasons for change

As indicated above, one of the categories of tax haven income subject to current taxation under the Subpart F provisions of the code is base company sales income. The Tax Reduction Act of 1975 contained an amendment which provides that base company sales income does not include the sale of agricultural commodities which are not grown in the United States in commercially marketable quantities. It has come to the committee's attention that questions have been raised as to the extent that this exclusion applies to agricultural products which are of different grade or variety from the same product grown in the United States. The committee believes that sales of foreign-grown agricultural products for use, consumption, or disposition outside the United States should not be included within the definition of foreign base company sales income. The committee is aware that these sales are highly competitive and that if the profits on these sales were subject to U.S. tax on a current basis, U.S.-controlled foreign companies could have difficulty competing with foreign-controlled companies. Accordingly, the committee believes it is appropriate to permit this category of income to retain the tax advantages of deferral until the profits are repatriated to the United States. [Emphasis supplied.]

20/ See H.R. 10612, Rep. No. 94-938, 94th Cong., 2d Sess, p. 471, June 10, 1976.

21/ See Report of the Committee on Finance, United States Senate, accompanying H.R. 10612, Rep. No. 94-938, 94th Cong., 2d Sess., pp. 232-233, June 10, 1976.

Explanation of provisions

The committee's amendment provides that for purposes of the tax haven foreign base company sales rules of Subpart F, personal property does not include agricultural commodities grown or produced outside the United States if sold for use, consumption or disposition outside the United States. The committee believes that this rule will be easier for the Internal Revenue Service to administer than either the rule contained in present law or the rule contained in the House bill."

Notwithstanding the rationale supporting this exception, the language was subsequently dropped from the Senate-passed Tax Reform Act of 1976 and the House-Senate conference owing to procedural considerations involving the Senate Finance Committee proceedings rather than substantive reasons. 22/

Nevertheless, it is significant that both the House Ways and Means Committee and the Senate Finance Committee had determined that important United States national and international interests would be served by preserving an ongoing opportunity for United States owned firms to participate in international agricultural trade, although the final provisions of the Tax Reform Act of 1976 left unchanged the language of the Tax Reduction Act of 1975 on this matter. 23/

22/ See H.R. 10612, 94th Cong., 2d Sess., August 6, 1976.

23/ See Tax Reform Act of 1976, P.L. 94-455, H.R. 10612, 94th Cong., 2d Sess., 90 Stat. 1520, October 4, 1976.

Economic and Transactional Distinctions Involving International Trading Operations

The decisions of the House Ways and Means Committee and the Senate Finance Committee to create a new Subpart F exception for income derived from sales of agricultural products produced abroad reflected awareness that in certain instances, United States interests are not served by taxing the operations of United States owned foreign corporations on a current basis. More specifically, the Congress recognized inherent economic distinctions between manufacturing and mining activities on the one hand and agricultural marketing and international trading operations on the other. These industries involve fundamentally different international economic and marketing considerations. A manufacturing company may utilize a trading affiliate in a low-tax jurisdiction to handle exports of its products manufactured within or without the United States. Owing to the nature of manufacturing processes, such arrangements could potentially displace United States exports of domestically manufactured goods as a consequence of the ability to shift manufacturing processes to various countries.

Conversely, trading of commodities in international commerce is not similarly susceptible to this form of shifting and United States export displacement. Grains, oilseeds, and other agricultural commodities are produced by individual farmers in particular countries. The nature and quantity of agricultural commodities available for export depends on matters such as climate, available land, etc. Although most production is consumed in the producing country, residual supplies are sold in world trade channels by exporters and intermediate resellers unrelated to the farmer-producers. International agricultural trading activities have traditionally involved a structure that includes trading companies (organized in low-tax jurisdictions) which are controlled by both United States-owned and foreign-owned companies.

International Commodities Trading

United States controlled foreign based trading companies compete in a complex business requiring skilled management and extensive resources. The basic role of international commodity traders is to anticipate demand for commodities throughout the world and to position themselves in relation to each of the basic elements of commodities trade--for example, the commodity itself, freight, foreign exchange and, in some cases, import levies--so that they can compete for sales as demand emerges. Back-to-back purchases and sales are rarely possible. Instead, positions must be taken before the emergence of new demand or new supply is fully reflected in price adjustments. Risk is unavoidable because values of each of the elements of a commodity trade are subject to continuous change. Effective management of risk in this environment is critical to success. Both the volume and value of the commodities involved in international transactions are enormous. Therefore, substantial working capital is required. Trading firms traditionally operate facilities required to handle and transport commodities.

The Need for Related Companies in International Trading Operations

Although theoretically, United States trading companies could avoid Subpart F problems by dealing only with unrelated companies, as a matter of practical necessity, this is not possible. As noted below, related companies have been required in many cases not for tax reasons but rather for business and marketing purposes.

A number of considerations are involved in deciding whether a domestic affiliated company is necessary to be competitive in buying commodities from or selling commodities to a particular country. In some cases they can serve no useful purpose. For example, the limited amount of business available may not justify the costs of organizing a separate company (Greece, Norway, Sweden, Kenya and Tanzania). Limitations imposed by the local government often are decisive (Eastern Europe and in the People's Republic of China). The dominant role of a government marketing agency may limit competitive opportunities for domestic affiliates (South Africa).

On the other hand, in other countries it is often necessary to use a local subsidiary engaged in domestic marketing, exporting and importing grain. To the extent that a significant free market operates within an exporting country, it is seldom possible to compete as an f.o.b. buyer with other international trading firms which can originate grain through offices and elevators controlled by a domestic affiliate. Sellers in these countries sometimes require and usually prefer to deal with a domestic subsidiary whose representatives are available to provide continuing service and whose assets are physically located within the jurisdiction of the host country. The same considerations often apply to selling grain in countries of ultimate destination. For example, most grain imported into the European common Market is handled by consumers on a levy-paid basis. The corporation paying the levy is required to register within the European Common Market, and therefore if a United States trading company wishes to export efficiently to the European Common Market, it must have local subsidiary corporations in the European Common Market countries.

Moreover, both in selling and buying countries, market intelligence gained through involvement in domestic market operations improves opportunities for concluding trades. This can be true even in countries in which government marketing boards play an important role (for example, Canada and Australia). Thus, the decision to organize and deal through a domestic affiliate both in buying and selling agricultural commodities turns mainly on business considerations as distinguished from tax considerations.

Typical Transactions

The following transactions will illustrate the operations of related companies in international agricultural trade; the limited scope of proposed exceptions; and competition at each stage among United States controlled and foreign controlled foreign based firms. In each case, transactions can involve the related company organized in the country or origin to purchase commodities from producers and local resellers; a related company operating in a country of ultimate use to receive the shipment, break it down, and resell it to local users; and, between these different entities, a separate risk taking profit center capable of assessing world market conditions anticipating demand, identifying supplies available from diverse sources, assembling other elements of an international transaction and putting them all together in a saleable package that meets the needs of sellers in originating countries and buyers in countries of ultimate use.

ABC Grain Copany, Ltd., a Canadian corporation may buy wheat from the Canadian Wheat Board and resell it f.o.b. Canadian port to ABC International, a United States affiliated international trading company. ABC International, in turn, will resell it c.k.f., or c and f, to an Italian buyer for redistribution to flour millers within Italy (Italian buyer may be a related company). In such a transaction, the ABC group of companies would compete at each stage with foreign controlled international commodities trading firms.

Sales of United States grains and other agricultural commodities to foreign destinations typically involve a number of different channels, usually beginning in a company organized in the United States. Sales of wheat to India, for example, almost always involve direct sales from a United States company to the Indian Buying Mission, which maintains offices in the United States. A sale of United States corn to Western Europe could involve a United States company as the f.o.b. seller to an affiliated international trading corporation. The affiliated international trading corporation, in turn, could resell c.i.f. to an unrelated third party for resale in Western Europe. A sale of United States wheat to the Soviet Union also might involve a sale by a United States company to an affiliated international trading corporation f.o.b. delivered on board at an American or St. Lawrence port and a resale by the affiliated international trading corporation to the Soviet grain buying agency.

Effects of Discriminatory Taxation on Competition between United States Owned Foreign Sales Companies and their Foreign Owned Competitors

Without an expanded agricultural commodities exception, United States owned international trading companies are subject to United States current taxation on undistributed earnings of most sales of agricultural commodities. Accordingly, foreign owned international trading companies, able to utilize arrangements which do not subject them to current taxation on income derived from these transactions, possess a decisive competitive advantage.

The effect of differential tax treatment can be illustrated by the following example:

A French owned trading company and a United States-owned trading company may engage in similar transactions involving international trade of agricultural commodities. Such commodities can originate from any of a number of major exporting nations, such as the United States, Canada, Brazil, Argentina, South Africa, Australia or the European Community, and move to a number of major importing areas, such as Western Europe, the Indian subcontinent, the Middle East, Central America, Japan, the People's Republic of China, the Soviet Union, or elsewhere. A French owned trading company and a United States-owned trading company may operate through similar facilities established in Panama in order to participate on a competitive basis in such international agricultural trade. Each of these companies may purchase soybeans grown in Brazil and ship the commodity to a European nation, realizing a profit of $100 on this type of transaction.

If a Panamanian trading company owned by United States interests is forced to pay accelerated United States income tax (current taxation of $46 by means of eliminating deferral), the United States based company would have substantially less capital available for competitive purposes ($54 as a result of the $46 United States tax on $100 profit). In contrast, a Panamanian trading company owned by French nationals would pay no immediate tax, as neither Panama nor France would impose a current tax on this type of transaction, thus, all $100 of pre-tax profits would be available for future competitive purposes.

Under these circumstances, the United States owned trading companies would not be able to compete with their foreign owned counterparts for these international sales of agricultural commodities.

Limited Capacity to Absorb Tax Disadvantages

Unlike United States owned firms manufacturing products abroad and distributing them in world markets through a foreign based sales company, United States traders in basic agricultural commodities in world markets possess no unique advantages like established brand franchises or product superiority to offset fundamental tax advantages. The products they offer--agricultural surpluses of other countries--are the same products offered by foreign based competitors, acquired from the same sources, and distributed to the same markets. Consequently, margins in this commerce have been historically very small.

Financing International Trade

An essential requirement for successfull competition in this trade is access to adequate amounts of capital. Major sources are retained earnings and borrowings. Impact of differential tax treatment on retained earnings is clear. However, the impact of differential tax treatment on the ability to borrow capital to finance trade is less clear, but equally important.

Capital requirements for international trading operations have increased significantly as commodity prices have risen above levels in the 1960s. Moreover, because prices now fluctuate through a broader range than before, the risks to lenders financing international agricultural trade has increased. Thus, risks associated with lending funds to international traders have increased simultaneously with their capital needs.

There is substantial competition for capital in this area, and foreign owned firms (operating with the same prudence and skill as United States owned firms) would have a substantial competitive edge over United States owned firms unless United States owned firms are placed on a similar tax footing.

Human Resources

As noted above, risk is unavoidable in international trading of agricultural commodities because the values of all elements of a commodity trade are subject to continuous change. Back-to-back transactions involving these elements are rarely possible and therefore success is heavily dependent upon human judgments of future events. Skilled merchants and traders, capable of managing risk in this environment, are an essential resource in international trading operations. United States owned firms cannot attract and hold skilled merchants and traders also sought by foreign based firms if, because of substantial tax advantages, earnings from operations reflecting the same level of skill and insight are no more than half the earnings of their foreign competitors.

Importance of United States Participation in International Trading of Agricultural Commodities to Stimulate United States Exports

An inability to compete effectively on an international basis in global commodities transactions severely limits the capacity of United States owned international trading companies to locate and expand markets for surplus agricultural commodities produced in this country.

The needs of buyers of agricultural commodities in international markets often can be met by suppliers from a number of possible origins. Indeed, sellers are often given the option of supplying agricultural commodities produced in different countries. United States owned international trading firms typically have substantially greater investments in facilities for originating, handling, transporting, storing and delivering agricultural commodities produced in the United States, and therefore have a greater incentive to encourage the purchase of commodities produced in this country wherever possible. Their inability to compete in all international transactions involving agricultural commodities would deprive the United States of opportunities that would otherwise exist for substituting exportable surpluses of agricultural commodities produced in the United States.

It is important for another reason that United States owned firms participate in transactions involving commodities produced abroad even where the possibility of substituting United States commodities does not exist. Market intelligence gained in these transactions increases the effectiveness of United States owned international trading firms in selling United States produced commodities abroad. Market intelligence enables a trader to anticipate events and to take positions before prices adjust to reflect the influence of new supply and demand. By trading in all international markets, United States owned international trading companies are better positioned to sell agricultural products produced in the United States.

Congressional Concern about the Competitive Position of the United States in International Trade Negotiations

Trade Act of 1974

In his opening statement of March 4, 1974, commencing the Senate Finance Committee hearings on the Trade Reform Act of 1973, H.R. 10710 (later to be voted into law as the Trade Act of 1974), Chairman Russell B. Long stated: 24/

> " I was very much in favor of the Trade Expansion Act of 1962. I still desire an 'open nondiscriminatory, and fair world economic system' but I am tired of the United States being the 'least favored nation' in a world which is full of discrimination. We can no longer expose our markets, while the rest of the world hides behind variable levies, export subsidies, import equalization fees, border taxes, cartels, government procurement practices, dumping, import quotas, and a host of other practices which effectively bar our products." [Emphasis supplied.]

GATT Reform

The Congress specifically instructed United States trade negotiators to seek revision of those GATT articles which discriminate against the United States. It is clear from the statutory language that the Congress was particularly concerned about GATT articles relating to taxes: 25/

24/ See Hearings before the Senate Finance Committee concerning The Trade Reform Act of 1973, H.R. 10710, Part 1, p. 2, 93rd Cong., 2d Sess., March 4 and 5, 1974.

25/ See §121 of the Trade Act of 1974, P.L. 93-618, H.R. 10710, 93rd Cong., 2d Sess., 88 Stat. 1978, January 3, 1975.

" The President shall, as soon as practicable, take such action as may be necessary to bring trade agreements heretofore entered into, and the application thereof, into conformity with principles promoting the development of an open, nondiscriminatory, and fair world economic system. The action and principles referred to in the preceding sentence include, but are not limited to, the following -

* * *

" The revision of GATT articles with respect to the treatment of border adjustments for internal taxes to redress the disadvantage to countries relying primarily on direct rather than indirect taxes for revenue needs . . ."

Congressional Oversight Involving International Trade Negotiations

The Senate Finance Committee has stated that the Congress will be actively involved in securing full reciprocity and equal competitive opportunities for United States interests: 26/

" The Trade Reform Act, as reported by the Committee, is intended to be more than a delegation of authority for negotiated reduction in the rates of duty. While a significant authority to reduce tariffs would be provided to insure the flexibility the trade negotiations will require, our foreign trading partners and our negotiators are on notice that the authority must be exercised to obtain full reciprocity and equal competitive opportunities for U.S. commerce."

House Ways and Means Committee Task Force on United States Taxation on Foreign Source Income

During the course of consideration of the Tax Reform Act of 1975, the House Ways and Means Committee established a special task force to study the United States taxation of foreign

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26/ See Report of the Senate Finance Committee accompanying H.R. 10710, p. 18, S. Rep. No. 93-1298, 93rd Cong., 2d Sess., November 26,

source income (sometimes hereinafter referred to as the "Foreign Source Income Task Force"). This task force was instructed to report its findings and recommendations to the full Committee. 27/

On March 8, 1977, the Foreign Source Income Task Force issued its report (sometimes hereinafter referred to as the "Foreign Source Income Task Force Report"). 28/ The task force recommended that no changes be made in the tax treatment of deferred earnings of foreign corporations controlled by United States shareholders. 29/ Its final statement on this matter confirms strong support for international and multilateral approaches to certain international tax policy issues (as distinguished from unilateral action under the Internal Revenue Code). The language chosen for this purpose is even broader in scope than the language contained in earlier draft reports: 30/

> "In its consideration of the several questions referred to it, the task force found that fundamental change by the United States in the taxation of foreign source income many areas requires the agreement and cooperation of foreign governments. Certain changes which might otherwise have been appropriate were found not to be acceptable if unilaterally adopted by the United States because they would subject U.S. businesses operating abroad to tax while their foreign competitors would not be similarly taxed, thus placing the U.S. businesses at a competitive disadvantage. Others were found to be unacceptable because they would subject foreign businesses to U.S. tax under circumstances involving a substantial possibility of retaliatory taxes by foreign governments against U.S. businesses operating abroad. Therefore, in addition to its specific recommendations directed toward the particular issues considered by the task force, the task force strongly recommends that steps be taken to initiate multilateral discussions between the United States and our major trading partners to consider a broad range of tax and investment questions, in particular those areas where unilateral action by any single nation is not feasible." [Emphasis supplied.]

27/ See Press Release No. 12, House Ways and Means Committee, January 5, 1976.

28/ See House Ways and Means Committee report entitled, "Recommendations of the Task Force on Foreign Source Income", 95th Cong., 1st Sess., March 8, 1977.

29/ Id. at p. 59.

30/ Id. at p. 2.

GATT Panel Decisions on Certain Tax Practices of the United States, France, Belgium and the Netherlands

GATT DISC Panel Decisions

In July 1973 a panel was established to examine a complaint submitted by the European Communities ("EC"), pursuant to paragraph 2 of Article XXIII of the GATT, relating to United States tax legislation on the Domestic International Sales Corporation ("DISC"), and to make such findings as would assist the Contracting Parties of GATT to make recommendations or rulings provided for in paragraph 2 of Article XXIII of GATT (this panel is sometimes hereinafter referred to as the "GATT DISC Panel").

The EC asked the GATT DISC Panel to find that the DISC system was incompatible with the relevant clauses of GATT regarding export subsidies. In the course of its proceedings, the GATT DISC Panel held consultations with the EC and the United States, and background arguments and information were submitted by both parties. In November 1976, the GATT DISC Panel concluded that the DISC legislation, in some cases, had effects which were not in accordance with United States' obligations under Article XVI(4) of GATT and that as it had found the DISC legislation to constitute an export subsidy which had led to an increase in exports it was also covered by the notification obligation contained in Article XVI(1) of GATT and that accordingly there was prima facie case of nullification or impairment of benefits under GATT.

GATT European Tax Practices Panel Decisions

Partially in response to the EC complaint, the United States initiated counter claims and proceedings against certain tax practices of France, Belgium and the Netherlands alleging that such tax practices constituted export subsidies in violation of GATT. Separate GATT panels were established in July 1973 to examine the United States complaints with respect to each of the subject countries, pursuant to paragraph 2 of Article XXIII of the GATT, and to make recommendations or rulings provided for in paragraph 2 of Article XXIII of the GATT (these panels are sometimes hereinafter collectively referred to as the "GATT European Tax Practices Panels").

The United States asked the GATT European Tax Practices Panels to find that certain tax practices of France, Belgium and the Netherlands violated Article XVI(4) of GATT and that these practices were, prima facie, nullifying or impairing benefits accruing to the United States under GATT.

The United States also suggested that the four complaints involving the DISC and certain tax practices of France, Belgium and the Netherlands should be considered together because they raised the same issues under GATT. In the course of its proceedings the GATT European Tax Practices Panels held consultations with the United States, France, Belgium and the Netherlands. Arguments and relevant background information were submitted by each of the parties.

In November 1976, the GATT European Tax Practices Panels concluded that the tax practices of France, Belgium and the Netherlands, in some cases, had effects which were in conflict with the respective obligations of these countries under GATT Article XVI(4) and that, since these practices had been found to constitute export subsidies which had led to obligations contained in Article XVI(1) of GATT and that accordingly there were prima facie cases of nullification or impairment of benefits under GATT with respect to the subject practices of each of these countries.

Representatives GATT Panel Findings and Determinations on Income Tax Practices of France

The GATT panel on French tax practices made the following findings of fact:31/

> "The French income tax system for corporations is based on the territoriality principle which, in general, taxes income earned in France but not income arising outside France. It is a principle deriving from the history of the French system dating back to the beginning of the century. French companies are liable to corporation tax solely in respect of profits made by enterprises operating in France and of profits taxable by France under an international double taxation agreement (Article 209:1 of Code Generale des Impots).
>
> Under the territorality rule as applied by France profits generated by undertakings operated abroad are exempt from French taxation. On the other hand, a French company is not entitled to any foreign tax credit and cannot deduct losses suffered abroad, apart from exceptions specified below.
>
> . . . .
>
> Ninety-five per cent of dividends from the French or foreign subsidiaries of a French company is excluded from the profits of the parent corporation. Participation by the parent in the subsidiary must exceed 10 per cent (Article 145 and 216 of CGI)."

31/ See Report of GATT Panel on Income Taxes Maintained by France, p. 2, November 2, 1976.

On the effects of the territorality principle as applied by France for taxation of foreign profits, the panel noted: 32/

> "The representatives of the United States pointed out that France followed the territoriality principle of taxation, and that as a result, did not tax the export sales income of foreign branches or foreign sales subsidiaries of domestic manufacturing firms. Taxes on such income were the most part permanently forgiven rather than merely deferred. He stated that the exclusion apparently extended to foreign source income from activities carried out by a French selling corporation through its own agents or employees abroad even without a foreign permanent establishment, as imcome from transactions which were separate from the corporation's French operations and which constituted complete commercial cycles outside France were excludable. The representative of the United States argued that these provisions, and relaxed intercompany pricing rules and other practices in relation to export transactions, created a distortion in conditions of international competition in that they afforded remission or exemption of direct taxes in respect of exports in violation of France's commitment as a contracting party under Article XVI:4. The permanent exemption could be freely used by the domestic manufacturing firm. The relative tax burden on the sales of products for export as against domestic sales was lower as a result of the remission.
>
> The representatives of the United States argued that, by organizing a foreign branch or subsidiary in a low-tax country, a French manufacturing firm could enjoy the low-tax rate on that portion of the total export sales income which was allocated to the foreign branch or foreign sales subsidiary, that the amount of export sales income allocated to foreign sources was generally substantial, that under the French system the right to tax foreign income was given up. He concluded that at a minimum the sales element of export earnings was exempt from taxation and therefore subsidized in violation of Article XVI:4."

32/ Id. at p. 4.

The panel stated the following concerning the effects of the territoriality principle as applied by France for taxation of foreign dividends: 33/

> "The representatives of the United States stated that under the territorial principle, profits of a foreign subsidiary were not consolidated with the profits of its French parent, and so not taxed in France. He went on to make the point that even if the subsidiaries' profits were repatriated in the form of a dividend, 95 per cent of it was deducted from the taxable income of the company, whether or not the foreign subsidiary was subject to taxes in its country of residence, and whether or not the rate of tax applied by that country was less than the French rate. In fact, the dividend was not expected to be taxed at all, as the remaining 5 per cent was considered to be deducted as ordinary expenses against the taxes of the recipient corporation. He argued that this amounted to a permanent exemption from taxation."

In its conclusion and recommendations, the panel determined the following: 34/

> "The Panel noted that the particular application of the territorality principle by France allowed some part of export activities, belonging to an economic process originating in the country, to be outside the scope of French taxes. In this way France has foregone revenue from this source and created a possibility of a pecuniary benefit to exports in those cases where income and corporation tax provisions were significantly more liberal in foreign countries.
>
> The Panel found that however much the practices may have been an incidental consequence of French taxation principles rather than a specific policy intention, they nonetheless constituted a subsidy on exports because the above-mentioned benefits to exports did not apply to domestic activities for the internal market. The Panel also considered that the fact that the practices might also act as an incentive to investment abroad was not relevant in this context.

33/ Id. at p. 7.

34/ Id. at pp. 11-13.

The Panel also noted that the tax treatment of dividends from abroad ensured that the benefits referred to above were fully preserved."

* * *

"The Panel therefore concluded that the French tax practices in some cases had effects which were not in accordance with French obligations under Article XVI:4."

* * *

"The Panel considered that the fact that these arrangements might have existed before the General Agreement was not a justification for them and noted that France had made no reservation with respect to the standstill agreement or to the 1960 Declaration (BISD, 9 Suppl. p. 32).

The Panel was of the view that, given the size and breadth of the export subsidy, it was likely that it had led to an increase in French exports in some sectors and, although the possibility could not be ruled out that the tax arrangements would encourage production abroad and a decrease in exports in other sectors, nonetheless concluded that it was also covered by the notification obligation of Article XVI:1.

In the light of the above, and bearing in mind the precedent set by the Uruguayan cases (BISD, 11 Suppl. p. 100), the Panel found that there was a prima facie case of nullification or impairment of benefits which other contracting parties were entitled to expect under the General Agreement."

GATT panels charged with responsibility for reviewing the income tax practices of Belgium and the Netherlands made findings and determinations similar to those for France, concluding that the tax practices of Belgium and the Netherlands were also in violation of GATT obligations.

Congressional Involvement in GATT Panel Proceedings

During the course of GATT Panel proceedings on DISC and certain tax practices of France, Belgium and the Netherlands, members of the House Ways and Means Committee and the Senate Finance Committee participated in the GATT sessions in Geneva, Switzerland. Members of the two Committees indicated that the United States should take a hardline position on these issues in international negotiations (as distinguished from United States unilateral action on DISC), and that such an approach was consistent with United States international tax and trade policy objectives and United States international negotiating opportunities.

Although these GATT Panel Decisions have been on the agenda for consideration by the GATT Council since March 1977, representatives of the European governments have resisted any further substantive consideration of these cases and have continued to postpone action on this matter.

Both the United States trade negotiators and the members of the House Ways and Means Committee and Senate Finance Committee who participated in these proceedings have been extremely disappointed in the unwillingness of the Europeans to press forward with the resolution of these cases, and members of the Committees have urged that the United States take a stronger position on the issues including possible unilateral action by the United States. The United States could substantially strengthen its hand in these international negotiations by enacting legislative changes, such as those recommended in this memorandum, to remove the present disadvantages under which United States firms now operate in international trade and thus place United States based international trading firms on a more equal tax footing with their foreign based competitors.

United States Congressional Concern about Substantial United States Trade Deficit with Japan

House Ways and Means Committee Task Force on United States-Japan Trade

Based on substantial concern about the increasing United States trade debate with Japan, the Members of the House Ways and Means Committee Subcommittee on Trade established a task force to consider this problem and to make recommendations. The report of the House Ways and Means Committee Task Force on United States-Japan Trade related that despite Japanese trade liberalization in recent years, a wide range of trade and structural barriers remain in Japan which restrict imports, interfere with the currency alignment process, and perpetuate the United States-Japan trade imbalance.

Members of the Task Force related that they had attempted to express this urgent message to Japanese government and business representatives, although such Members were not sure that they were heard or understood. In some cases, it was felt that Japanese officials believed that the situation was serious and were trying to correct the problems, while in other cases, the Members encountered absolutely no understanding of how destructive Japan's excessive trade surpluses were to the world economy, and how much concern these trade imbalances had created in other nations.

The Members related the following in the Task Force Report: 35/

> "We have offered some observations and proposals on these longer range issues. Some of these proposals extend outside of the jurisdiction of the Subcommittee on Trade and involve issues such as tax policy, antitrust, export promotion, and government organization.
>
> We hope that interested parties will comment on the proposals in this report and assist the Subcommittee in exploring ways to deal with the problems we have identified. The need is urgent for a long-range national policy to deal with these international trade issues." [Emphasis supplied.]

* * *

> "It is probable that in addition to curbing domestic inflation, more important, long-range encouragement of exports rests with the U.S. Government in terms of
>
> (a) tax incentives, consistent with U.S. multilateral obligations, which will encourage firms to undertake the heavy costs of entering new markets;

35/ See House Ways and Means Committee, Subcommittee on Trade Task Force Report on United States-Japan Trade, 95th Cong., 2d Sess., pp. V, 6, 44 and 45, January 2, 1979.

(b) relaxation or exemption of anti-trust laws in certain overseas situations, while continuing competition domestically;
(c) increased emphasis in the United States on industrial R & D innovation;
(d) access to capital for small U.S. firms selling or operating abroad;
(e) willingness to match the full range of export credit services offered by foreign export organizations (pending agreement with trading partners to limit such export competition);
(f) better organization of Federal government to encourage U.S. commercial interests abroad and to give more emphasis and visability to the importance of exports." [Emphasis supplied.]

* * *

"It is probable, however, that more important, long-range encouragement of exports rests with the U.S. Government in terms of such issues as:
(a) tax incentives;
(b) clarification of U.S. anti-trust laws to export sales abroad;
(c) renewed R & D emphasis along with easier conversion of R & D into industrial innovation;
(d) access to capital for small U.S. firms selling/operating abroad;
(e) improved Eximbank services;
(f) increased coordination among, and status for U.S. agencies promoting exports;
(g) development of the trading company concept for U.S. companies.

While we recognize that many economists question the need for export promotion programs, particularly in a world of freely floating exchange rates, we are concerned that this view is somewhat unrealistic in light of the many export promotion programs provided by our major competitors. For example the Library of Congress has recently prepared a report entitled "Export Stimulation Programs in the Major Industrial Countries: The United States and Eight Major Competitors," which contains several table comparisons showing the need for the United States to (1) either obtain agreement among its trading partners to limit export promotion programs or (2) to improve the quality of its own programs.

Therefore, we believe that the general ideas listed above should be discussed at greater length.

1. The Task Force is reviewing a number of proposals in the general area of taxation to encourage U.S. competition in world markets. It is important,

of course, that any such changes not violate existing GATT rules or provide the kind of export subsidies which will be covered by the Subsidies Code in the MTN Agreement." [Emphasis supplied.]

Advantages Provided by the Japanese Government to Japanese Trading Companies

Although major Japanese trading companies are publicly owned, large Japanese banks and insurance companies often own substantial blocks of the stock of such trading companies. Japanese trading companies typically operate through a Japanese parent corporation and various local subsidiary corporations in countries where the trading company does business.

Japanese trading companies rely extensively on debt financing as the primary source of funds for international business operations, and debt to equity ratios of such companies are exceedingly high by United States standards. Interest is deductable, and net profits after interest tend to be relatively modest owing to substantial debt carried by the trading ocmpanies. A key factor supporting the competitive position of Japanese trading companies in world trading markets is the extent to which debt is considered to be permanently invested in the business. In this regard, it is particularly important to understand the manner in which debt and equity are generally viewed in Japan. Japanese banks which provide permanent short-term debt, although not having strict voting power as a shareholder, nevertheless because of the unusually high debt to equity ratios (seldom less than 9 to 1), have a very real direct influence on the thrust and direction of Japanese trading companies. It is implicit in this almost partnership-like relationship that the banks will not call their loans should the trading company run into temporary unfortunate trading experiences. This type of relationship, although not found, nor probably permitted, in the United States, nevertheless, accounts for the relatively substantial exposures that a Japanese trading company may undertake. Apparently this type of financing is an integral part of the total Japanese economic system which encourages and permits Japanese trading companies to engage in very large volume and very low margin business which in turn promotes Japanese industrial growth margins.

The Japanese system has other built-in advantages, such as limited, if any, concern about anti-trust considerations, intercompany investments, and seemingly inexhaustible availability of credit. Of course, none of these advantages are readily available under the United States system.

The following excerpt from a business periodical recognizes the advantages which accrue to Japanese trading companies and supports the points noted above. 36/

> "There are 6,000 or so trading companies in all, but most of the business is done by the Big Six (which also includes C. Itoh & Co., Marubeni Corp., Sumitomo Shoji and Missho-Iwai Co.).
>
> The trading companies do things which would send the Justice Department rushing into court if American companies did them. Often their business comes to them from banks that are large investors not only in the trading companies but also in the companies whose goods the trading firms deal. Thus, for example, Dai-Ichi Kangyo Bank owns nearly 10% of C. Itoh & Co.; Fuji Bank owns over 7% of Marubeni Corp. Both banks are large investors in several textile companies with which the two trading companies do business. There is ample room for restraining trade and fixing prices by Japanese managers who tend to be more interested in orderly markets than abstract principles of perfect competition.
>
> Their balance sheets would shock most American security analysts. They go after huge volumes with razor-thin margins - usually 3%, often less - on the theory that profits will take care of themselves. And they do it all on a shoestring, piling ponderous debt on minimal equity. With a debt-to-equity ratio of 9.4 (based on total debt), Mitsubishi is the group's least leveraged outfit." [Emphasis supplied.]

The Congress should modify the United States tax system to permit, and indeed to encourage, United States-owned trading companies to compete with Japanese trading companies by adopting tax arrangements more in line with other countries of the Western World.

36/ See A Business in Billions, A Profit in Thousands, Forbes, p. 90, July 10, 1978.

Subsidies and Countervailing Duty Code

During the course of the MTN, United States negotiators attempted to obtain greater discipline over the use of subsidies that confer unfair competitive advantages upon the products of foreign competitors. The results of these efforts are embodied in the Subsidies and Countervailing Duty Code ("Subsidies Code") which has now been signed by all the major industrialized countries. This represents an interpretation and elaboration of GATT Articles VI, XVI and XXIII, relating to subsidies and countervailing measures.37/ Key elements of the Subsidies Code include the following:

"1. A flat prohibition on export subsidies on nonprimary products as well as primary mineral products;

2. Special rules for developing countries under which signatories would agree to reduce and eliminate their export subsidies on nonprimary products, as well as primary mineral products;

3. Illustrative provisions on subsidies other than export subsidies which recognize the legitimacy of such programs but also recognize that such subsidies may cause injury or serious prejudice, or nullify or impair GATT benefits accruing to their signatories, particularly when such subsidies are granted on noncommercial terms, and a commitment to seek to avoid such trade effects and provision for remedies where they are causes;

4. Improved rules on agricultural export subsidies, with particular reference to interests in third-country markets;

5. A two track set of remedies designed to provide expeditious countermeasures when subsidized competition causes problems in the United States market or in United States export markets;

6. A dispute settlement mechanism designed to provide quick resolution of subsidy and countervailing disputes and to provide a growing case law in the GATT on such problems."

37/ See Subsidies/Countervailing Measures Text of the Multilateral Trade Negotiations Group on Nontariff Measures, subgroup on Subsidies and Countervailing Duties, April 5, 1979.

Under the provisions of the Subsidies Code, the signatories recognized that while subsidies are often used by governments to promote important objectives of social and economic policy, subsidies also may cause adverse effects to the interests of other signatories. The signatories agreed not to use export subsidies in a manner inconsistent with the provisions of the Subsidies Code.

Article 9 of the Subsidies Code, pertaining to export subsidies, provides: 38/

> "1. Signatories shall not grant export subsidies on products other than certain primary products.
>
> 2. The practices listed in points (a) to (l) in Annex are illustrative of export subsidies."

Article 18, Section 6 of the Subsidies Code, pertaining to dispute settlement and review, provides: 39/

> "6. The Committee shall review annually the implementation and operation of this Agreement taking into account the objectives thereof. The Committee shall annually inform the CONTRACTING PARTIES to the GATT of developments during the period covered by such reviews.[1]
>
> [1] At the first such review, the Committee shall, in addition to its general review of the operation or Agreement, offer all interested signatories an opportunity to raise questions and discuss issues concerning specific subsidy practices and the impact on trade, if any, of certain direct tax practices." [Emphasis supplied.]

Note 2 of the Annex to the Subsidies Code provides: 40/

> "The signatories recognize that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected. The signatories further recognize that nothing in this text prejudges the disposition by the Contracting Parties of the specific issues raised in GATT document L/4422." [Emphasis supplied.]

The language cited above expressly provides that the GATT Panel Decision involving DISC is not covered by the Subsidies Code, and based on an earlier draft of the text it appears that the GATT Panel Decisions involving the tax practices of France, Belgium and the Netherlands are also not covered by the Subsidies Code.

38/ Id. at p. 20.

39/ Id. at p. 35.

40/ Id. at p. 40.

Accordingly, despite the major efforts of United States trade negotiators, it is clear that the Subsidies Code does not resolve the basic issues of direct tax incentives for exports and that it sidesteps the findings under the GATT Panel Decisions, although the Subsidies Code Committee is obligated to provide the United States an opportunity to raise again the matter of the impact of direct tax practices on trade. This provides further support for the proposition that the United States Congress should now proceed with the changes in the United States tax law recommended in this memorandum to protect important United States interests and to provide needed negotiating leverage to United States trade negotiators in the forthcoming international deliberations on these issues.

Further Deterioration in United States Trade Account

In its recent report on the United States trade account, the United States Department of Commerce Bureau of Economic Analysis related the following with respect to the continuing and increasing United States trade deficit: 16/

> "The U.S. merchandise trade balance was in deficit by $12.2 billion in the first quarter of 1980, compared with a deficit of $8.6 billion in the fourth quarter of 1979,..." [Emphasis supplied.]
>
> * * *
>
> "The deficit was the largest since the $11.9 billion deficit registered in the first quarter of 1978. Imports increased $7.0 billion, or 12 percent, to $66.2 billion. Higher prices, especially for petroleum and metals, accounted for half the increase; volume increased 6 percent. (Prices are measured by the Census Bureau's unit value index; first-quarter data are incomplete.) Exports increased $3.4 billion, or 7 percent, to $53.9 billion; volume increased 5 percent."
>
> * * *
>
> "Agricultural exports declined $0.2 billion, or 2 percent, all in volume, to $10.3 billion. The decline was concentrated in grain and soybeans. Exports of wheat, corn, and soybeans to the Soviet Union fell sharply to 95.5 million bushels from 208.7 million bushels in the fourth quarter, principally because of the partial embargo on shipments of grain and soybeans to the Soviet Union announced on January 4." [Emphasis supplied.]

16/ See United States Department of Commerce News, pp. 1-2, May 7, 1980.

United States Trade Representative's Support of Expanded Use of United States International Trading Companies to Promote United States Exports

In his recent testimony before the House Ways and Means Committee Subcommittee on Trade on July 20, 1980, United States Trade Representative Reubin Askew stated the following in suggesting that the United States could do a better job of paying for its increasing oil bill without running such large trade deficits if the United States enjoyed a larger share of overall world trade: 17/

> "We are persuaded in the administration that one constructive means of facilitating increased exports of goods and services by American producers is through the development and use of export trading companies."
>
> * * *
>
> "Aside from the major international grain companies, we do not have large export trading entities in the United States. To be sure, there are between 700 and 800 export management companies in the United States, many of them well-managed and successful businesses. Most are quite small, however, and cannot provide the full range of services needed by the novice exporter." [Emphasis supplied.]
>
> * * *
>
> "Clearly, there is no single model for an American export trading company. We cannot and should not simply copy the devices or practices of other countries. Instead, we must isolate the essential characteristics of successful exporting entities and blend them with our necessary traditional principles of sound banking and economic competition. I am confident that we can do this in a way which will allow the creation and the successful operation of export trading companies such as are envisioned in this legislation. These trading companies will, in turn, help us achieve increased exports, increased competitiveness, and, thus, increased prosperity." [Emphasis supplied.]

17/ See testimony of United States Trade Representative Reubin Askew before the United States House of Representatives Committee on Ways and Means Subcommittee on Trade, pp. 9, 13, 29, July 21, 1980.

CONCLUSION AND RECOMMENDATIONS

It is difficult to generalize concerning the effect of foreign tax systems with respect to taxation of foreign source income. Nevertheless, it should be noted that, despite varied approaches to taxation (worldwide, territorial, and certain forms of exemptions and credits), generally the major free market trading nations of the world do not tax currently the undistributed earnings and profits of a foreign subsidiary controlled by local residents. Accordingly, to the extent that the United States taxes these earnings, United States based companies engaged in international trade operate at a substantial competitive disadvantage.

During consideration of the Tax Reduction Act of 1975, the Tax Reform Act of 1976, the Tax Reduction Act of 1978, the deliberations of the House Ways and Means Committee Task Force on Taxation of Foreign Source Income, the House Ways and Means Committee Task Force on United States-Japan Trade, the GATT Panel Decisions, the Subsidies Code and most recently the deliberations and recommendations of the House Ways and Means Committee and the Senate Finance Committee concerning the Tokyo Round of MTN international agreements and related domestic legislation, the United States Congress had indicated an increasing awareness that, in certain instances, United States interests are not serviced by taxing currently the undistributed earnings and profits of United States owned foreign corporations.

More specifically, the Congress has recognized inherent economic distinctions between manufacturing and production operations on the one hand, and international marketing and trading activities on the other. These industries involve fundamentally different transactional considerations. A manufacturing company may utilize a trading affiliate in a low-tax jurisdiction to handle exports of its products manufactured within or without the United States. Owing to the nature of manufacturing processes, such arrangements could potentially displace United States exports of domestically manufactured goods (and United States jobs) as a consequence of the ability to shift manufacturing processes to foreign countries. Conversely, trading operations in international agricultural commodities are not similarly susceptible to this form of shifting which could result in displacement of United States exports and jobs.

Unless the United States provides an exception from current taxation of earnings and profits of United States owned firms derived from international trading activities (similar to the practice of other countries which do not tax such income on a current basis), the competitive position of United States trading firms will be undermined and ultimately this business will be transferred to foreign owned firms beyond United States tax jurisdiction and control.

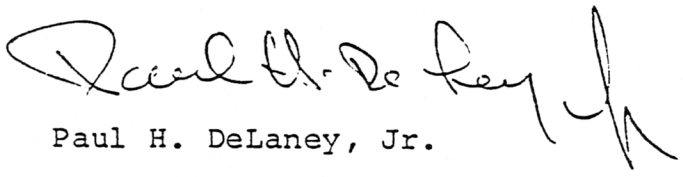
Furthermore, the significant, continuing United States trade deficit suggests that it is extremely important that United States-owned international trading firms be provided an opportunity to compete on a substantially equivalent tax footing with foreign owned firms in world trade. Unless United States firms are accorded tax treatment similar to that accorded their foreign owned competitors, United States firms will be displaced in world trading markets. United States firms trading in agricultural commodities possess no special advantages which would enable them to absorb significant additional tax burdens. United States firms buy and sell the same products and commodities as their foreign owned competitors.

During the consideration of the Trade Act of 1974, various members of Congress expressed concern about the United States position in world trade, specifically noting the need for an open nondiscriminatory and fair world trading system. It was recognized that the United States could no longer expose its markets while other nations utilize all manner of government-instituted practices to effectively bar United States products and distort international trade.

Members of the House Ways and Means Committee, the Senate Finance Committee and the Congress as a whole have stressed the need for utilizing both international and domestic approaches with respect to United States international tax and trade policy issues so as to preserve important United States interests. Unfortunately, because of the continuing refusal of various European countries to accept and implement the GATT Panel Decisions and the inability of United States trade negotiations to obtain changes in international rules on the use of direct tax export incentives under the provisions of the Subsidies Code (despite major efforts by our trade negotiations in both of these areas), the United States is now faced with a pressing need to make changes in United States tax law to obtain comparability with the tax practices of other countries which compete with the United States for world trading markets.

Based on the points, authorities, developments and considerations set forth above, it is urged that the Members of the House Ways and Means Committee, the Senate Finance Committee and the Congress as a whole proceed expeditiously with necessary changes in United States federal income tax law early in the 97th Congress to assure that changes in the United States owned firms engaged in international trading of agricultural commodities will be placed on a substantially equivalent tax footing with their foreign owned competitors.

Respectfully submitted,



Paul H. DeLaney, Jr.

ATTACHMENT A

General Considerations Regarding
United States Taxation of Foreign Source Income

Tax Jurisdiction and Taxation of Foreign Source Income

A particular nation may tax the worldwide income of its nationals, restrict the scope of its tax jurisdiction to a territorial basis (tax only domestic source income), or provide for other means of limiting the taxation of foreign source income.

In response to a United States Congressional inquiry in March 1973, a study was prepared under the auspices of the Council on International Economic Policy ("CIEP") (regarding tax treatment by other nations of their own multinational firms (taxation of foreign source income). 1/

This study summarized the basic rules of the following countries with respect to taxation of foreign source income: Belgium, Brazil, Canada, Denmark, France, Federal Republic of Germany, Ireland, Italy, Japan, the Netherlands, Norway, Switzerland, and the United Kingdon.

The analysis included:

1. Taxation of income of foreign branches of domestic corporations;

2. Taxation of foreign subsidiaries of domestic corporations;

3. Taxation of interest, dividends and patent royalties received from abroad; and

4. Treatment of foreign taxes paid by domestic corporations and their subsidiaries (in certain instances, inter-company pricing practices were considered)

1/ See information submitted for the record by the Council on International Economic Policy to the Subcommittee on International Trade, Senate Finance Committee, Hearings on Multinational Enterprises, February 26 through March 6, 1973.

Although it is difficult to generalize concerning the effect of foreign tax systems with respect to taxation of foreign source income, it should be noted that despite varied approaches to taxation (worldwide, territorial, and varied forms of exemptions and credits), not one of the nations considered in the CIEP study taxed currently the undistributed profits of a foreign subsidiary controlled by local residents. Accordingly, to the extent that the United States taxes undistributed profits of United States controlled foreign corporations on a current basis, this places United States based companies engaged in international operations at a competitive disadvantage and constitutes a departure from the general scheme of international taxation practiced by other nations.

United States Constitutional Considerations

In accordance with the principal taxation provisions of the Constitution of the United States (sometimes hereinafter referred to as the "Constitution"), the United States Congress (sometimes hereinafter referred to as the "Congress"), possesses the power to lay and collect, taxes, duties, imposts, and excises to pay the debts and provide for common defense and general welfare of the United States, provided such duties, imposts and excises shall be uniform through the United States. 2/

Under the Constitution, as initially ratified, the Congress could only impose direct taxes in proportion to the census (apportionment on the basis of population). 3/ However, pursuant to Constitutional Amendment, the Congress is now empowered to lay and collect taxes on income from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration. 4/ Although the Congress has exercised its Constitutional tax authority in enacting the provisions of the United States Internal Revenue Code, 5/ administration of United States federal income tax laws has generally been delegated to the United States Treasury Department and the Internal Revenue Service. 6/

2/ See U.S. Const. Art. I, Sec. 8.

3/ See U.S. Const. Art. I, Sec. 9.

4/ See U.S. Const. Amend. XVI.

5/ See Internal Revenue Code of 1954, as amended, Title 26 U.S.C. §1 et seq. (sometimes hereinafter referred to as the "I.R.C.").

6/ The Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, is charged with the responsibility for prescribing and publishing rules and regulations for the enforcement of United States income taxes. See I.R.C. §62.

United States Tax Jurisdiction

United States federal tax jurisdiction is based on two general principles: 7/

1. Nationality, under which the United States taxes worldwide income of "United States persons"; 8/ and

2. Source of income, under which the United States taxes "United States source income" of United States persons and "foreign persons", including "nonresident aliens" and "foreign corporations" (in limited circumstances, the United States taxes "foreign source income" of foreign persons "effectively connected with a United States trade or buisness").

Accordingly, under relevant provisions of the Internal Revenue Code, nonresident aliens and foreign corporations are subject to United States federal income tax on: 9/

1. Income derived from United States sources; and

2. Income effectively connected with a United States trade or business.

The term "United States person" includes United States domestic corporation. 10/

7/ I.R.C. §§1 and 11(a) set forth very broad jurisdictional rules, imposing tax on the taxable income of "every individual" and "every corporation", respectively.

8/ The term "United States person" and other relevant terms pertaining to United States tax jurisdiction are defined and discusses subsequently in this memorandum.

9/ See I.R.C. §§871, 872, 881 and 882 which limit United States tax jurisdiction with respect to taxation of nonresident aliens and foreign corporations to income from sources within the United States and income effectively connected with the conduct of a United States trade or business.

10/ I.R.C. §7701(a)(30) defines "United States person" to include citizens, residents, domestic partnerships, domestic corporations and domestic estates and trusts.

United States Taxation of United States Corporations and Foreign Corporations

As noted above, United States tax jurisdiction is based on both nationality and source of income. The United States taxes United States persons (citizens, residents, corporations, partnerships, trusts, etc.) on income from all sources.

The modern United States corporate income tax dates from 1909. At that time, domestic corporations were taxed on income from all sources and foreign corporations on income from business transacted and capital invested within the United States. This jurisdictional pattern remained substantially unchanged until 1962.

The impact of tax on the foreign source income of United States persons was softened somewhat in 1918 with the adoption of a foreign tax credit. Previously, foreign taxes had merely been deductable, like state and local taxes. The credit can apply to both the earnings and profits of foreign subsidiary corporations and foreign branches. Only payments treated as income taxes, or "in lieu of income taxes", qualify for the credit. 11/

The income of foreign corporations, if derived from business conducted outside the United States, is generally not subject to current United States income taxation.

In broad terms, a corporation is treated as a United States domestic corporation if it is incorporated in any of the states of the United States or the District of Columbia and is treated as a foreign corporation if it derives its charter from a foreign government.

Foreign source income earned by a foreign corporation controlled by United States persons is generally exempt from United States taxation until distributed to shareholders who are United States persons. 12/ The effect of these provisions of the Internal Revenue Code is that a United States person (United States shareholder) is

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11 See I.R.C. §§901-906.

12/ See I.R.C. §§1, 11, 861-864, 881-883, and 1201.

allowed to defer paying United States income tax on undistributed earnings and profits of a controlled foreign subsidiary corporation until such earnings and profits are repatriated to the United States (this development is often referred to as "deferral" of tax with respect to foreign investment).

A corporation recieving a dividend from a controlled United States domestic corporation is generally entitled to exclude most of that dividend from its taxable income on the theory that it has already been subject to tax. 13/ Dividends from a foreign corporation are not entitled to this exclusion. Likewise, dividends from a foreign corporation are not entitled to the $100 exclusion of dividends received by individuals. 14/ Therefore, United States shareholders of foreign corporations are generally taxed fully on dividends received from foreign corporations.

A United States corporation which in any taxable year owns at least 10 percent of the voting stock of a foreign corporation from which it received dividends is entitled to a foreign tax credit for income taxes paid by that foreign corporation. 15/

Current Taxation of Undistributed Earnings and Profits of Foreign Corporations

Although United States shareholders (United States persons) of foreign corporations are generally not subject to United States tax on the income of such foreign corporations unless, and until, such income is repatriated to the United States in the form of dividends (or remittances in the nature of a dividend), United States shareholders of two categories of foreign corporations are effectively subject to current United States taxation on certain types of undistributed income:

1. "Foreign personal holding companies"; and

2. "Controlled foreign corporations".

13/ See I.R.C. §243.

14/ See I.R.C. §116.

15/ See I.R.C. §902.

United States Taxation of Foreign Personal Holding Companies

A foreign corporation is treated as a foreign personal holding company:

1. If at least 60 percent of the corporation's gross income for the taxable year is foreign personal holding company income (passive income such as dividends, interest, rents and royalties); and

2. If at any time during the taxable year, more than 50 percent in value of the corporation's outstanding stock is held directly or indirectly by not more than five individuals who are citizens or residents of the United States. 16/

The rationale for the foreign personal holding company provisions is to prevent a small group of United States taxpayers from incorporating their investments overseas in order to escape taxation of investment income at the individual level. The shareholders of a foreign personal holding company are subject to current United States taxation on their pro-rata share of the corporation's personal holding company income.

16/ See I.R.C. §§551-558.

United States Taxation of Controlled Foreign Corporations Under Subpart F

In accordance with the provisions of the Revenue Act of 1962, 17/ the United States Congress added Subpart F to the Internal Revenue Code in an effort to deal with the problem of tax haven operations. 18/ Under this approach, United States shareholders of controlled foreign corporations ("CFCs") are subject to current United States income taxation on certain forms of undistributed tainted income (tax haven or Subpart F income):

1. Subpart F income, including foreign base company income and income derived from insurance of United States risks;

2. Previously untaxed Subpart F income withdrawn from investment in less developed countries; and

3. Any increase in investment in United States property to the extent it would be taxable as a dividend if distributed to United States shareholders.

It should be understood that Subpart F taxes United States shareholders not on their own income, but on the income of CFCs in which they own an interest. This development relates to the consideration that there may be no jurisdictional basis for taxing a foreign corporation unless it earns income from sources within the country asserting jurisdiction to tax (or has income effectively connected with business operations in such country). Therefore, Subpart F jurisdiction is predicated on United States citizenship or residence, rather than source of income.

Controlled Foreign Corporations

A CFC is defined as a foreign corporation whose total combined voting power of all classes of stock entitled to vote is more than 50 percent owned, on any day during the taxable year, by United States shareholders. 19/

17/ See Revenue Act of 1962, P.L. 87-834, H.R. 10650, 87th Cong., 2d Sess., 76 Stat. 960, October 16, 1962.

18/ See I.R.C. §951(a)(1).

19/ See I.R.C. §957.

A "United States shareholder" is defined as a United States person owning, actually or constructively, 10 percent or more of the total combined voting power of a CFC. 20/

Foreign Base Company Income

Foreign base company income (as noted before, foreign base company income is included in the definition of Subpart F income) is computed on the basis of three components: 21/

1. Foreign personal holding company income;

2. Foreign base company sales income; and

3. Foreign base company services income.

For operational purposes, a primary issue often pertains to tax treatment of foreign base company sales income. Essentially, a CFC engaged in buying and selling personal property to, from, or on behalf of, a related person is treated as generating foreign base company sales income, unless the property has been manufactured, produced, grown, or extracted in the CFC's country of incorporation or is intended to be used, consumed, or disposed of in that country, or both. 22/ These rules are designed to subject to current taxation the income of CFCs primarily engaged in selling, as opposed to manufacturing or similar activities.

In applying the foreign base company sales income rules, the income of a branch operation outside the CFC's country of incorporation is treated as foreign base company sales income of the CFC when use of the branch has substatntially the same tax effect as if the branch were a wholly-owned subsidiary. 23/ The Treasury Income Tax Regulations set forth detailed rules for making this determination with respect to both sales and manufacturing branches. The effect of this procedure is to prevent avoidance of tax by United States shareholders on income which in substance is identical to foreign base company sales income where the existence of such income would not otherwise be recognized because of formal unity of a CFC and its branch as a single corporate entity. 24/

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20 See I.R.C. §951(b).

21/ See I.R.C. §954(a).

22/ See I.R.C. §954(d)(1).

23/ See I.R.C. §954(d)(2).

24/ See Treas. Reg. §1.954-3(b).

Legislative Chronology of Subpart F

In accordance with the legislative history of Subpart F under the Revenue Act of 1962, it is clear that the United States Congress adopted the percentage of voting power test contained in Section 957 (pertaining to the definition of a controlled foreign corporation) and specifically rejecting percentage of value and effective control tests, recognizing that United States shareholders should only be taxed currently on undistributed foreign corporate profits where such shareholders possess sufficient power to cause payment of dividends.

An anlaysis of the specific legislative chronology on this matter reveals the following:

1. Treasury Department's original proposal to tax United States shareholders currently on undistributed earnings of foreign corporations was rejected by Congress as overreaching;

2. In a second and narrower proposal, the Treasury Department pressed Congress to adopt a definition for CFCs which would be based on either a value test or a voting power test (it should be noted that the Congress, on its own initiative, did not consider a test beyond a voting power test);

3. Despite the suggestions and arguments of the Treasury Department, the Congress selected the voting power test to determine CFC status.

4. The Congress concluded that United States shareholders should not be taxed on undistributed earnings of a foreign corporation unless such shareholders had the requisite voting power to cause the declaration and payment of dividends.

5. The Congress was aware of other types of tests for determining CFC status, such as percentage of value, practical control, effective control, etc. (the Congress had often used such various control tests either individually or in combination to remedy specific problems) and therefore, it is particularly significant that the Congress did not select any test other than that of voting power for the CFC definition.

House Ways and Means Committee Hearings

It is important to recognize that early in the process of the legislative history of Subpart F, various members of the House Ways and Means Committee expressed concern about the apparent approach of the Treasury Department regarding standards for the definition of a CFC. Apparently, the Treasury had hoped to give the newly-proposed taxing mechanism the broadest possible scope as demonstrated by its proposal that with respect to a corporation created after enactment of the legislation, any United States shareholder owning ten percent or more of the stock of a foreign corporation would be taxed on its share of the foreign corporation's earnings even though no other United States shareholder owned stock in the subsidiary, i.e. a 10 percent ownership test rather than a 50 percent ownership test would be applied to new foreign subsidiaries.

This approach attracted substantial opposition within the House Ways and Means Committee, and the Treasury Department withdrew the proposal and advanced another. The second Treasury initiative provided that a ten percent or greater United States shareholder would be taxed currently on its pro rata share of the foreign corporation's income only if five or fewer United States shareholders owned either (1) more than 50 percent of the voting power, or (2) more than 50 percent of the value, of the foreign corporation's stock. 25/ Under this method, the Treasury's test of control was a two-pronged alternative test, i.e. ownership of either more than 50 percent in value or voting power would cause a foreign corporation to be classified as a CFC.

Again, key members of the House Ways and Means Committee expressed reservations about this type of control test. Senior Committee member Hale Boggs and ranking Republican member John Byrnes (recognized within the Committee as active and knowledgeable members in the foreign income area) doubted that the United States had the power to pierce the veil of foreign corporate entities in the manner proposed by the Treasury, despite Secretary of the Treasury Dillon's opinion that the manner in which United States shareholders of foreign personal holding companies were taxed established that the Treasury approach was legally proper. Accordingly, Congressman Boggs (who was not satisfied with Secretary Dillon's statement) asked that the staff of the Joint Committee on Internal Revenue Taxation prepare and submit a memorandum to the House Ways and Means Committee on this issue, such memorandum to be made an official part of the record of the hearings. 26/ As noted below, this Joint Committee staff memorandum provides better evidence of Congressional intent on this issue than the pronouncements of the Treasury.

25/ See U.S. Treas. Dept. Press Release D-186 (July 28, 1961).

26/ See Hearings on President's 1961 Tax Recommendations Before the House Ways and Means Committee, Vol. 1, p. 310, 87th Cong., 1st Sess., May 4, 1961.

Treasury Department Legal Memorandum

In a legal memorandum from General Counsel of the Treasury Department Robert H. Knight to Secretary of the Treasury Dillon, it was the opinion of the Treasury Department that the subject Treasury proposal, including both the 50 percent threshold test for existing foreign corporations and the 10 percent threshold test for future foreign corporations, would be held valid under the United States Constitution both with respect to the taxing power and the power to regulate foreign commerce. 27/

Joint Committee Staff Legal Memorandum

The Joint Committee staff memorandum confirmed the basic concern and thinking of members of the House Ways and Means Committee, particularly on the question of the appropriateness under the United States Constitution of subjecting United States taxpayers to current tax treatment with respect to undistributed corporate income on the basis of constructive receipt: 28/

> "The administration's proposal is that the income earned by foreign corporations be taxed to the American shareholders without any distribution or dividend declaration. This raises certain basic questions as to whether or not the shareholder has income within the meaning of the 16th amendment when he has received nothing and does not have the right and power to demand any payment. [Emphasis supplied.]

The staff memorandum emphasized the separateness of corporate entities, even in the case of a United States subsidiary wholly-owned by a foreign government, and distinguished the Subpart F proposal from the foreign personal holding ocmpany provisions which were described as a special case which must be viewed as depending on the power of Congress to prevent an obvious tax-evasion device. Finding no basis to justify current dividend-like taxation of undistributed foreign corporate earnings, the staff memorandum further concluded that the constructive receipt had no application because the United States shareholder had no power to declare a dividend and therefore lacked the power to demand the payment which makes the constructive receipt doctrine operative. Accordingly, the Joint Committee staff memorandum rejected The Treasury Department's contentions and adopted the view that only when a United States shoreholder possessed the power to declare a divident would the constructive receipt theory provide an appropriate basis for current taxation.

27/ See memorandum prepared by the United States Treasury Department entitled, "Opinion re Proposal to Include in Gross Income of United States Shareholders Undistributed Earnings and Profits of a Controlled Foreign Corporation", June 12, 1961.

28/ See memorandum prepared by the staff of the Joint Committee on Internal Revenue Taxation entitled, "Constitutional Power to Tax Shareholders on Undistributed Income of a Corporation", p. 311.