

UNITED STATES TAX LEGISLATION (DISC)

*Report of the Panel presented to the Council of Representatives on 12 November 1976  
(L/4422 - 23S/98)*

1. The Panel's terms of reference were established by the Council on 30 July 1973 (C/M/89, paragraph 6):

"To examine the matter referred by the European Communities to the CONTRACTING PARTIES pursuant to paragraph 2 of Article XXIII, relating to United States tax legislation on Domestic International Sales Corporations, and to make such findings as will assist the CONTRACTING PARTIES in making the recommendations or rulings provided for in paragraph 2 of Article XXIII."

2. The Chairman of the Council informed the Council of the agreed composition of the Panel on 17 February 1976 (C/M/112, paragraph 17):

Chairman: Mr. L.J. Mariadason (Counsellor, Permanent Mission of Sri Lanka, Geneva)

Members: Mr. W. Falconer (Director of Trade Policy, Department of Trade and Industry, Wellington)

Mr. F. Forte (Professor of Public Finance, University of Turin)

Mr. T. Gabrielsson (Counsellor of Embassy, Permanent Delegation of Sweden to the European Communities, Brussels)

Mr. A.R. Prest (Professor of Economics of the Public Sector, London School of Economics)

3. In the course of its work the Panel held consultations with the European Communities and the United States. Background arguments and relevant information submitted by both parties, their replies to questions put by the Panel as well as all relevant GATT documentation served as a basis for the examination of the matter. In addition, Canada gave a presentation of its support for the European Communities' complaint, in accordance with its request to the Council (C/M/89, paragraph 6).

4. The Panel met on 16-18 March, 28 June-1 July and 26-30 July 1976 and concluded its report through a postal procedure.

5. The European Communities requested the Panel to find that the DISC system was incompatible with the relevant clauses of the General Agreement regarding export subsidies. Canada submitted in addition that the Panel should recommend to the United States that it should terminate subsidization promptly.

Factual aspects of the DISC legislation

6. The following is a brief description of factual aspects of the DISC legislation as the Panel understood them.

7. The United States tax system finds its origin in the first income tax act, the Revenue Act 1913. Under this system corporations and their shareholders are separately taxed. The United States taxes the entire world-wide income of its domestic corporations, allowing a foreign tax credit against United States tax for income taxes paid abroad.

8. Prior to 1962 the United States did not tax the foreign source income of a foreign corporation organized outside the United States. Taxes on that income were deferred until the income was repatriated. When "sub-part F" was enacted in the Revenue Act of 1962, the United States began taxing currently to the United States shareholders of controlled foreign corporations the income from certain sales and services of these foreign subsidiaries.

9. Intercompany pricing rules, adopted first in 1924, follow the arm's-length principle.

10. The next major change was the introduction of the DISC system. The Domestic International Sales Corporation statute came into force on 1 January 1972 and was incorporated in the United States Internal Revenue Code as Sections 991 to 997.

11. To qualify as a DISC, a United States corporation must meet specific requirements, including requirements that it be a domestic corporation, that 95 per cent of the corporation's gross receipt for each taxable year consists of "qualified export receipts" and that 95 per cent of the corporation's assets at the close of the taxable year be "qualified export assets".

12. A United States corporation that qualifies as a DISC is not subject to United States federal income tax on its current or retained export earnings. However, one half of a DISC's earnings is deemed distributed to the shareholders of the DISC and is taxable to those shareholders as a dividend. A liability of shareholders to taxation on the retained earnings arises when one of the following events occur: (a) there is an actual distribution of untaxed DISC earnings, (b) the DISC is liquidated, (c) a shareholder disposes of the DISC stocks, or (d) the corporation fails to qualify as a DISC for the taxable year.

13. Special intercompany pricing rules permit a rule of thumb allocation of export sales income between the parent company and the DISC. These rules provide that a DISC's profits are taken to be an amount which does not exceed the greater of: (a) 4 per cent of its export sales receipts, or (b) 50 per cent of the combined taxable income of the DISC and its related supplier, or (c) taxable income based upon the price actually charged to the DISC by its related supplier if that price is justifiable on an arm's-length basis. In the case of either (a) or (b) the DISC can earn an additional profit equal to 10 per cent of related export promotion expenses. The rules cannot be applied so as to create in the parent a loss on a sale.

14. In most cases total profits of a manufacturing company and its DISC combined exceed 8 per cent and the 50-50 split of profits between the parent and the DISC is chosen. Since one half of the DISC's profits are deemed distributed to its parent, the net effect is as if 75 per cent of the export profits were allocated to the parent manufacturer and taxed currently. Twenty-five per cent is allocated to the DISC and tax on this is deferred, without attracting interest for the period involved, in contrast to the general practice in the case of late payment of corporation income tax.

15. The definition of "export promotion expenses" says *inter alia* that "such expenses shall also include freight expenses to the extent of 50 per cent of the cost of shipping export property aboard airplanes owned and operated by United States persons or ships documented under the laws of the United States in those cases where law or regulations does not require that such property be shipped aboard such airplanes or ships".

16. The number of companies electing for DISC treatment has developed as follows.<sup>1</sup> By the end of March 1972, three months after the legislation came into effect, 1,136 DISC's had been created. By the end of 1972 the figure was 3,439; by the end of 1973 it was 4,825; by the end of 1974 it was 6,738 and by the end of 1975 it was 8,258. By the end of February 1976 the number of DISCs

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<sup>1</sup>1974 Annual Report on the Operation and Effect of the DISC legislation, April 1976. had reached 8,382. However, some DISCs are inactive, many companies have more than one DISC, and the data are not adjusted for DISCs that have been liquidated or withdrawn their elections.

17. DISC exports accounted in DISC year 1974 for about \$43.5 billion, or 61 per cent of total United States exports in calendar year 1973.<sup>1</sup> According to the "International Economic Report of the President" 70 per cent of United States exports went through DISCs in 1975 and it is estimated that DISC exports will account for approximately three quarters of total United States exports in 1976.

18. The revenue cost of DISC in the form of foregone tax collections was estimated at \$105 million in the fiscal year 1972 and \$460 million in 1973. The tax deferred on the \$3.1 billion of income earned by DISCs in DISC year 1974 amounted to \$756 million.<sup>1</sup> It is projected to reach \$1,580 million in the fiscal year 1977.

19. During the first two and a half years of DISC operation (January 1972 to July 1974) United States exports were stimulated by fluctuations in exchange rates, a sharp economic expansion abroad and widespread shortages of agricultural products. It is therefore especially difficult to evaluate both the influence of DISC on United States exports as well as any offsetting increase in United States imports. There is also a time lag between the creation of a DISC and its full impact.<sup>1</sup>

20. It is estimated that United States exports in DISC year 1974 were about \$4.6 billion higher than they would have been without the DISC legislation. These additional exports may have provided about 230,000 jobs in the export sector in the DISC year 1974.<sup>1</sup>

21. According to a statement of the Secretary of the United States Treasury on 13 April 1976, projections indicate that the effect of the DISC legislation on exports in 1976 could be as large as \$9 billion.

22. The largest categories of DISC exports have been agricultural products, chemicals, machinery, and transportation equipment. The geographical distribution of DISC exports closely corresponds to that of total United States exports except that DISC exports shipped to Canada are disproportionately low.<sup>1</sup>

#### Main arguments

23. Many of the arguments made by the European Communities were also advanced by Canada.

#### A. Article XVI:1

24. The representative of the European Communities argued that the avowed object of the DISC legislation and the recognized effect of its application was to operate "directly or indirectly to increase exports", thereby constituting a subsidy which should have been notified under Article XVI:1 under the periodic communications provided for. In particular, the party concerned was required to provide inter alia information on the "estimated quantitative trade effects ... and the reason why it is considered that the subsidy will have these effects". In this respect the European Communities considered it reasonable to expect that in the context of such information the party would likewise provide precise particulars concerning the effects of the subsidy on prices.

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<sup>1</sup>1974 Annual Report on the Operation and Effect of the DISC legislation, April 1976. The DISC year differs from calendar years because the DISC returns have a variety of accounting periods. DISC year 1974 refers to accounting periods ending between 1 July 1973 and 30 June 1974. Approximately 82 per cent of the export sales reported on the tax returns covered by the 1974 Report were shipped

during calendar year 1973.

25. The representative of Canada argued that the obligation in Article XVI:4 to ensure that any subsidy did not result "in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market" was an obligation assumed by the contracting party paying the subsidy, and it would be reasonable to assume that when notifying under Article XVI:1 contracting parties should show that the subsidy did not result in bi-level pricing in the above-mentioned sense. This was because authorities in countries adversely affected by subsidies did not have access to detailed information about the pricing practices of exporters within the jurisdiction of another contracting party. To assume that the onus fell on the complainant made paragraph XVI:4 virtually inoperative, a result that could not have been intended by the CONTRACTING PARTIES.

26. The representative of the United States maintained that an obligation to notify presupposed that a party maintained an export subsidy. Since the United States had no reason to regard the DISC legislation as a subsidy in view of past GATT documentation regarding the definition of subsidies, it had no obligation to notify it under Article XVI:1. The issue of notification had been raised by the European Communities and Canada only in an attempt to escape the burden of demonstrating bi-level pricing, which had to be shown even if the DISC system were to be determined an export subsidy.

#### B. Article XVI:4

27. The representative of the European Communities argued that the declared objective of the DISC was to provide a substantial stimulus to United States producers to increase their export sales, and that the DISC system constituted an export subsidy which was incompatible with United States obligations under Article XVI:4 and the Declaration of 19 November 1960 giving effect to the provisions of that paragraph.

#### Items (c) and (d) of the 1960 list

28. The representative of the European Communities referred to the illustrative list of measures which governments prepared to accept the Declaration giving effect to Article XVI:4 - including the United States Government - considered in general to be subsidies within the meaning of Article XVI:4 (BISD, 9 Supp., p. 186) and in particular to items (c) and (d) of that list, which referred respectively to "the remission, calculated in relation to exports, of direct taxes ... on industrial or commercial enterprises", and "the exemption, in respect of exported goods, of charges or taxes, other than charges in connection with importation or indirect taxes levied at one or several stages on the same goods if sold for internal consumption". An unlimited deferral of taxes was, according to the European Communities, the equivalent in economic terms to an exemption since the deferral granted by the DISC legislation was unlimited because there was no rule in the legislation which in practice prevented the deferral from being maintained indefinitely. There was, similarly no rule that the profits of a DISC must be distributed within a certain period of time and the DISC system provided many ways in which the profits could be used without being distributed and thereby attracting tax, e.g. assets of a DISC could include producer's loans and stocks or securities of a related foreign export corporation. The system, therefore, did not afford a limited advantage but total exemption from direct federal corporation taxes for one half of the profits of a DISC accruing from exports.

29. The representative of the European Communities observed that DISC corporations were in general fictitious subsidiaries, i.e. subsidiaries with no personnel, no inventories and no operating costs of their own. The DISC corporations usually operated as mere export commercial agents of the producing parent. The last annual report by the United States Treasury on the operation of the DISC system showed that only a very small number of corporations (six out of about 8,000 corporations involved) had to give up the benefits inherent in DISC legislation. In any case, even assuming that a corporation

were not to meet the 95 per cent criterion, official publications provided that subject to certain conditions, a corporation might maintain its qualification as a DISC and continue deferral on its qualified income by distributing the non-qualified income or assets as a taxable dividend to its shareholders. If distributions were not made or the DISC wished to terminate its status, the accumulated income of the DISC was taxable to the DISC's shareholders over a ten year period, or such shorter time as the DISC had been in existence.<sup>1</sup>

30. Lastly, the representative of the European Communities claimed that even if tax deferral were to end sometime, either in exceptional circumstances or through the elimination of the DISC system, there would still be the exemption of the compound interest on the deferred tax.

31. The representative of the United States argued that the DISC legislation was not subsidy on exports within the meaning of Article XVI:4. He said that the only official action taken by the CONTRACTING PARTIES to define subsidies was the adoption on 19 November 1960 of the Working Party's report<sup>2</sup> containing an illustrative list of practices which are considered by governments adhering to the Declaration of 19 November 1960 Giving Effect to the Provisions of Article XVI:4<sup>3</sup> generally to be subsidies for the purposes of Article XVI:4. Items (c) and (d) were included in the list, whereas neither tax deferral, tax exemption for foreign source income nor other more complex specific direct tax practices were referred to in the Working Party Report. The illustrative list did not cover the DISC legislation because it was only a deferral and not a remission or exemption, cancellation, release or forgiveness of direct taxes calculated in respect of exports. A number of arguments dealt with under the section "Relation to practices of other countries" below were also relevant.

32. The representative of the United States also cited secretariat document COM.IND/W/73 in support of his conclusion that up to now there had been no agreed interpretation of the GATT rules with respect to the deferral of direct taxes.

33. He agreed that a deferral could have the same economic effect as an exemption if the deferral extended for a sufficiently long period of time but maintained that the benefits of the DISC legislation were sufficiently uncertain as to duration and amount to negate any analogy to remission or exemption of taxes. One reason for this was that continued deferral depended on the ability to qualify as a DISC for each taxable year. He also stated that it was often difficult to meet the 95 per cent "qualified export assets" test, that the most useful assets in this regard were the trade receivables generated on export sales of the parent of the DISC but that the ability to use these depended upon exports growing at an increasingly rapid rate. Uncertainties had led many major accounting firms to require their clients to provide currently for the full amount of deferred tax, supporting the view that the DISC legislation provided only for a deferral.

34. The representative of the United States also said that the DISC legislation had been controversial domestically since its introduction and that the threat of its repeal was constantly present. This made it unlikely that businessmen could treat the deferral as an exemption and use the deferred earnings accordingly.

35. The representative of the United States argued that tax deferral was an aspect of any tax system insofar as no system ensured collection of taxes as income accrued. He stated that there were a number of other cases in which taxes on a transaction did not become due until some period of time after the occurrence of the event that gave rise to the tax. In reply to a question he stated that in his country failure to pay taxes when due would in general carry a penalty tax which "does bear a conceptual relationship to an interest rate because it is measured on the time of the delay".

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<sup>1</sup>"DISC - A Handbook for Exporters", United States Department of the Treasury, 27 January 1972, p.8.

<sup>2</sup>BISD, 9 Suppl., p. 185-188.

<sup>3</sup>BISD, 9 Suppl., p. 32-33.

#### Item (h) of the 1960 list

36. The representative of Canada stated that, even if a DISC should be required to pay its income tax at some point, the system would constitute an export subsidy in terms of item (h) of the 1960 list: "The government bearing all or part of the costs incurred by exporters in obtaining credit".

#### Inter-company pricing rules

37. The representative of the European Communities noted that the scale of the advantage afforded by the DISC system depended on the proportion of profits accruing from export transactions which could be attributed to the DISC. He argued that the 4 per cent and 50 per cent rules of thumb were inconsistent with the arm's-length principle under which profits were allocated to different, even if closely related, entities by reference to conditions of fully effective competition.

38. The representative of the United States held that the DISC legislation had brought its inter-company pricing rules more closely into line with those of other countries with respect to exports and added that the treatment of export sales income allowed under tax practices in many European countries was substantially equivalent to, and in many cases more favourable than, that provided by the DISC provisions. For instance, the DISC legislation in most cases established a 75-25 allocation of profits between those currently taxable and those subject to tax deferral while some GATT member countries provided for a 50-50 allocation of profits between those taxable and those subject to complete exemption.

#### Relation to practices of other countries

39. The representative of the United States argued that the DISC legislation removed an existing distortion rather than creating a new distortion in international trade.

40. He recalled that a number of countries including several countries belonging to the European Communities including France, Belgium and the Netherlands did not tax currently the export sales income of foreign branches or foreign sales subsidiaries. In addition, many countries also wholly or partially exempted from taxation export earnings repatriated by a foreign sales subsidiary to its parent while the United States taxed that income. By organizing a foreign branch or subsidiary in a low-tax country, the domestic manufacturing firm could enjoy the low-tax rate on that portion of the total income which was allocated to the foreign branch or subsidiary as export sales income, and, since inter-company pricing rules were leniently applied in many countries, a substantial portion of the combined income could be shifted to the sales subsidiary in the low-tax jurisdiction. He argued that before the introduction of the DISC legislation, United States exporters had been at a disadvantage compared with exporters in those countries as a result, inter alia, of sub-part F of the Internal Revenue Code, which had the effect of taxing currently to the United States shareholders sales income of foreign base companies when the goods were produced in the United States and sold for use outside the country of incorporation. On the other hand, the tax law provided for deferred tax on income from direct United States investment in manufacturing facilities abroad.

41. He added that, instead of correcting this imbalance in a way which would have increased the attractiveness of foreign tax havens, the United States had preferred to adopt the DISC legislation to offset for United States corporations the competitive advantage previously enjoyed by exporters in other countries and to neutralize taxation as a consideration for United States firms in deciding whether to locate manufacturing facilities in the United States or abroad.

42. The representative of the United States went on to argue that, while the other countries measures to which he had referred created a distortion, they had never been regarded as subsidies for the purposes of the GATT and that when they accepted the illustrative list, the member States of the European Communities could therefore not have had a reasonable expectation that a system such as that introduced by the DISC legislation was contrary to Article XVI:4. He also argued that, since the subsequent practices of the parties to a Treaty represented proper criterion for its interpretation according to the Vienna Convention on the Law of Treaties, the question arose as to whether the continued existence of the tax practices of member States of the European Communities and other countries indicated the existence of a consensus that such practices, including the DISC legislation, did not constitute subsidies nullifying or impairing Article XVI obligations.

43. The representative of the European Communities replied that the tax practices of European countries referred to by the United States did not create distortions but were simply methods of avoiding international double taxation in cases where sales were made, for economic reasons, from abroad. On the other hand, the DISC system was designed to cover cases where a fixed establishment or a subsidiary was not considered necessary from the economic aspect by the American company which engaged in direct sales from United States territory. He said that certain countries avoided double taxation by means of the exemption method while others, such as the United States, used the credit method. The representative of the European Communities argued that these two methods were considered to be equivalent by the OECD which had left each member State free to make its own choice between them, and the United States had itself recognized that the two methods were equally acceptable.

44. The representative of the European Communities argued that even without the introduction of the DISC legislation there was, if anything, a distortion which favoured United States corporations. The United States, for instance, considered a corporation as a foreign corporation if it had been incorporated under foreign legislation, regardless of the location of its actual management headquarters. This permitted the creation of base corporations in tax haven countries with actual management headquarters in the United States but whose profits were deemed to originate abroad. The introduction of sub-part F therefore only reduced the disadvantage of European firms, being taxed the moment their actual management headquarters were located at home. Moreover, the disadvantage was only slightly reduced because sub-part F was itself of limited effectiveness, both because of the rules of ordinary law concerning foreign tax credit and because of the difficulties encountered in implementing legislation which implied knowledge of data concerning foreign corporations. He also recalled the fact that certain exceptions were made to sub-part F in sub-part G of the same legislation, and was still applicable to base corporations set up prior to October 1971. In fact, he said, it was clearly shown that DISC corporations had simply been replaced by the former base corporations in the functioning of export advantage.

45. The representative of the European Communities stated that the determination of transfer prices had not been applied less strictly in European countries than in the United States.

46. The representative of the European Communities maintained therefore that no distortion in favour of European corporations existed before the introduction of the DISC system. He added that, even if such a distortion had existed, the DISC system would have been quite unsuited to correct it, regardless of whether or not it was consistent with the GATT, because even if it might have been justified vis-à-vis the countries in question, it would have been totally unjustified vis-à-vis other contracting parties whose tax systems operated under the world-wide principle and did not give rise to any problems. He argued also that in no case did corporations in the European states mentioned enjoy equivalent advantages with respect to their direct sales from these states, that the DISC legislation created a new tax haven in the United States itself and that it therefore created a new distortion in trade relations.

47. Turning to the legal arguments advanced by the United States, the representative of the European

Communities said that the fact that European countries' practices had never been regarded as subsidies could not be a justification for the DISC legislation, since it was different in nature from these practices and that the reference by the United States to a limited number of cases was insufficient evidence of the existence of a consensus. He also pointed out that the United States was claiming, on the one hand, that there was a tacit agreement between the parties that the practices of European countries were in conformity with the General Agreement and, on the other hand, that those practices were contrary to the Agreement.

48. In reply the representative of the United States explained that the exceptions in sub-part G, to which reference had been made, were never widely used and were not available to new export trade corporations after the taxable year beginning 31 October 1971. Few, if any, of the older corporations were active today. He also argued that DISC subsidiaries were easier for the administration to survey than foreign sales corporations. He further said that he did not question the territorial system insofar as it represented a reasonable approach to the avoidance of double taxation. However, it eliminated double taxation by exempting foreign income from tax and thus could result in the remission of direct taxes on exports or in the exemption of taxes on exported goods. He also stated that he did not argue two inconsistent propositions, but if the DISC legislation were to be regarded as a subsidy the other systems must also be regarded as subsidies.

#### Export promotion expenses

49. The representative of the European Communities stated that the provision allowing 10 per cent of export promotion expenses to be assigned to the DISC constituted a direct subsidy of these expenses.

50. The representative of the United States referred to the GATT secretariat document COM.IND/W/73 and said that "deduction of export promotion or market development expenses" were included in the "grey area" where there was no agreed interpretation of GATT rules.

#### Bi-level pricing

51. The representative of the European Communities said that in the Communities' view, the DISC legislation constituted inter alia a remission or exemption in terms of paragraphs (c) and (d) of the illustrative list of practices subject to the 1960 Declaration, and in respect of which a presumption of bi-level pricing existed.

52. In any event, the representative of the European Communities argued that the United States was in the best position to provide the information from which the incidence of bi-level pricing might be determined. Although the United States was, in the view of the Communities, obliged to provide this in accordance with its obligations under Article XVI:1, it had not done so, and this had made it difficult to provide an analysis showing the precise practical bi-level pricing effect of the DISC legislation. Furthermore as had been stressed by the representative of Canada attempts to investigate bi-level pricing practices had been obstructed by United States authorities.

53. Moreover, the representative of the European Communities argued, the criterion of double pricing might be interpreted, by analogy to the concept of "increased exports" in Article XVI:1 and the concept of "increased quantities" in Article XIX (as elaborated in BISD, Vol. II, pp. 44-45), as meaning price maintenance for export purposes, or as meaning a price lower than it would have been in the absence of the export subsidy. He went on to argue that in fact the United States itself had held that it was sufficient that a practice might lead to prices lower than would otherwise have been the case in its notifications in the Inventory of Non-Tariff Barriers (MTN/3B/1-5, Add.5 notifications 18.2, 30.2, 34.1 and 47.2).

54. The representative of the European Communities went on to argue that the DISC system permitted a lowering of export prices, that the intended aim of this legislation was to increase exports, and that the United States Treasury and Commerce Departments and Congress had confirmed in their analyses that United States exports had increased as a result of the operation of the DISC system. He questioned how such exports could have increased if the system had had no effect on export prices.

55. Nevertheless the European Communities submitted to the Panel calculations of how the DISC system would enable exporters to lower their prices without lowering their profitability and cited statements from United States legislative and business sources to the effect that the DISC provisions had enabled actual reductions in prices.

56. The representative of the United States accepted that those tax practices which clearly fell within the 1960 illustrative list did carry the presumption of bi-level pricing but that practices not in the list, including tax deferral, did not carry that presumption. He said therefore that, even if the DISC legislation were to be determined to constitute a subsidy within the meaning of Article XVI:4, the European Communities had also to give a convincing factual demonstration that (a) goods were sold for export at prices below those at which they were sold domestically and (b) that these lower prices were caused by DISC. The sales should be statistically significant in terms of number of transactions, dollar volume of sales and number of companies and products involved. The European Communities had failed to sustain its burden of establishing such proof.

57. The representative of the United States stated that the data the European Communities argued that the United States was in the best position to provide did not presently exist. He pointed out that the last Treasury Department report on the operation and effect of the DISC legislation showed that the combined profit of DISCs and related suppliers from producing and exporting products was higher than the rate of return in the domestic economy. The only available evidence therefore indicated that companies had maximized profits by maintaining prices or increasing exports rather than reducing export prices. Market considerations were the principal factor in establishing export prices, not tax considerations, and exports had increased because the expected profitability of export sales had induced leading firms to seek out new foreign markets, to give priority to export sales, etc. Finally, exchange rate fluctuations and the general expansion in economic activity and world trade, undoubtedly accounted for the bulk of the expansion of the United States exports since 1972. Quotations from United States business and legislative sources on price reductions should be disregarded because these did not state that the products in question were sold at a price lower than the comparable price charged for the like product to domestic buyers. The term subsidy as used in a political debate had little relevance for the meaning of a subsidy under Article XVI:4. Neither was a Non-Tariff Barrier notification equivalent to recognition of a subsidy under Article XVI:4.

58. The representative of the United States made the additional point that under the theory used to justify the GATT border tax adjustment rules, direct taxes were not considered to be borne by goods and were held to have no price effect. It would seem logical that relief from direct taxes would therefore also have no price effect and could not result in bi-level pricing.

59. In this connection, the representative of the European Communities recalled that in its conclusions the Working Party on border tax adjustments had recognized that the extent to which direct and indirect charges were shifted on to prices was a particularly complex problem on which the Working Party had not reached unanimous views.

C. Article XVI:3

60. The representative of Canada said that DISC might, over time, give the United States more than an equitable share of world exports of those primary products exports which continued to attract DISC

benefits.

61. The representative of the United States denied the Canadian assertion and added that this question was outside the Panel's terms of reference as primary products were not covered by Article XVI:4, under which the European Communities' complaint on the DISC legislation was lodged.

D. Import replacement

62. The representative of Canada argued that, by improving the competitive position of United States manufacture, the DISC system might over time - though benefits reaped from economies of scale - operated indirectly as a subsidy replacing imports into the United States, thus impairing the value of tariff concessions under the GATT.

E. Flag discrimination

63. The representative of the European Communities claimed that flag discrimination resulting from a clause in the DISC legislation relating to sea and air transport seemed incompatible with the spirit of the General Agreement. By referring to this aspect the Community wished to show that the DISC system, far from neutralizing the fiscal practices of other parties, was in fact meant to promote American exports as well as related activities. The relevance to the GATT was clear from the fact that the opportunities of a DISC to deduct 50 per cent of transport costs as an expense for export promotion, on condition that the goods were carried on United States ships, had direct repercussions on the actual cost of transport as the advantage of tax exemption according to the Communities' calculations, might amount to 2.5 or even 3 per cent of the freight charges and hence have a direct influence on trade.

F. Article XXIII:2 - Nullification or impairment of benefits

64. The representative of the European Communities maintained that the DISC legislation conflicted with the provisions of Article XVI:4 and that a prima facie case of nullification and impairment therefore existed. He cited the Uruguayan case to support this contention (BISD, 11 Suppl, p. 100). He also pointed out that the United States Treasury annual reports on the effects of the DISC system, other official United States sources and statements by American firms showed that the DISC legislation had led to an increase in United States exports. He concluded that the interests of a number of contracting parties had been seriously prejudiced.

65. The representative of Canada, supporting the European Communities, said that benefits which Canada reasonably expected under the General Agreement had been nullified or impaired.

66. The representative of the United States argued that a mere technical breach of the General Agreement would not suffice as grounds for the successful invocation of Article XXIII and that a showing of injury was a prerequisite to the finding of nullification or impairment that the European Communities sought. As the DISC legislation was not a violation of Article XVI:4, the only case left was a non-violation nullification or impairment which in the opinion of the United States required a showing of injury. He concluded that since there was no evidence of bi-level pricing there was no evidence of injury to the European Communities and that the European Communities had failed to demonstrate that the DISC legislation nullified or impaired any benefit accruing to them under the General Agreement.

Conclusions

67. The Panel started by examining the effects of the DISC legislation in economic terms. The Panel concluded that it conferred a tax benefit and that this benefit was essentially related to exports. The

Panel considered that if the corporation income tax was reduced with respect to export related activities and was unchanged with respect to domestic activities for the internal market this would tend to lead to an expansion of export activity. Therefore the DISC would result in more resources being attracted to export activities than would have occurred in the absence of such benefits for exports.

68. The Panel noted that the United States Treasury had acknowledged that exports had increased as a result of the DISC legislation and the Panel considered that the fact that so many DISCs had been created was evidence that DISC status conferred a substantial benefit.

69. The Panel noted that the DISC legislation was intended, in its own terms, to increase United States exports and concluded that, as its benefits arose as a function of profits from exports, it should be regarded as an export subsidy.

70. The Panel examined whether a deferral of tax was "a remission" in terms of item (c) or "an exemption" in terms of item (d) of the illustrative list of 1960 (BISD, 9 Suppl. p. 186).

71. The Panel was not convinced that a deferral, simply because it is given for an indeterminate period, was equal to a remission or an exemption. In addition it noted that the DISC legislation provided for the termination of the deferral under specified circumstances. The Panel further noted, however, that the deferral did not attract the interest component of the tax normally levied for late or deferred payment and therefore concluded that, to this extent, the DISC legislation constituted a partial exemption which was covered by one or both of paragraphs (c) and (d) of the illustrative list.

72. The Panel noted that the contracting parties that had accepted the 1960 Declaration had agreed that the practices in the illustrative list were generally to be considered as subsidies in the sense of Article XVI:4. The Panel further noted that these contracting parties considered that, in general, the practices contained in the illustrative list could be presumed to result in bi-level pricing, and considered that this presumption could therefore be applied to the DISC legislation. The Panel concluded, however, from the words "generally to be considered" that these contracting parties did not consider that the presumption was absolute.

73. The Panel considered that, from an economic point of view there was a presumption that an export subsidy would lead to any or a combination of the following consequences in the export sector: (a) lowering of prices, (b) increase of sales effort and (c) increase of profits per unit. Because the subsidy was both significant and broadly based it was to be expected that all of these effects would occur and that, if one occurred, the other two would not necessarily be excluded. A concentration of the subsidy benefits on prices could lead to substantial reductions in prices. The Panel did not accept that a reduction in prices in export markets needed automatically to be accompanied by similar reductions in domestic markets. These conclusions were supported by statements by American personalities and companies and the Panel felt that it should pay some regard to this evidence.

74. The Panel therefore concluded that the DISC legislation in some cases had effects which were not in accordance with the United States' obligations under Article XVI:4.

75. The Panel examined the significance of the various options under the DISC legislation for the allocation of profits from export sales between parent companies and DISCs, and concluded that these could influence the size of the exemption.

76. The Panel concluded that the provision allowing the deduction of certain shipping costs by DISCs (on the condition that exports be carried in United States vessels), and the provision allowing 10 per cent of export promotion expenses to be assigned as a deductible expense to a DISC would appear to confer additional pecuniary benefits.

77. The Panel considered 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.

78. While the Panel noted that primary product exports were eligible for DISC benefits and had been traded substantially through DISCs, it did not examine whether the benefits would result in the United States obtaining a disproportionate share of the world market in terms of Article XVI:3.

79. The Panel noted the United States argument that it had introduced the DISC legislation to correct an existing distortion created by tax practices of certain other contracting parties. However, the Panel did not accept that one distortion could be justified by the existence of another one and considered that, if the United States had considered that other contracting parties were violating the General Agreement, it could have had recourse to the remedies which the General Agreement offered. On the other hand, the fact that tax practices of certain other countries had been in force for some time without being the subject of complaints was not, in itself, conclusive evidence that there was a consensus that they were compatible with the General Agreement.

80. In the light of the above and bearing in mind the precedent set by the Uruguayan case (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.