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MYRES S. McDOUGAL DISTINGUISHED LECTURE

GLOBAL HUMAN RIGHTS: CHALLENGES AND PROSPECTS
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Professor Ferguson, in the third annual Myres S. McDougal Distinguished Lecture, discusses two basic theoretical problems in global human rights: whether there is an international basis for a consensus on human rights; and the selection of a suitable "organizing principle" for declaring the substance of those rights. Despite the difficulties involved in establishing a true universal basis for these rights, and determining the form these rights will take, Professor Ferguson finds a rising tide of hope in the increasing recognition that there is an irreducibe minimum of rights which attach to people as human beings

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THE EUROPEAN COURT OF JUSTICE JUDGMENT IN UNITED BRANDS: EXTRATERRITORIAL JURISDICTION AND ABUSE OF DOMINANT POSITION
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Over the past few years, the Commission of the European Communities and the European Court of Justice have begun to establish a body of antitrust law based on Articles 85 and 86 of the Treaty of Rome. The decision in *United Brands*, announced by the Court of Justice in February 1978, provides one of the clearest expositions to date of the article 86 concept of "abuse of a dominant position." The factual situation of *United Brands* enabled the Commission and the Court of Justice to be in substantial agreement in finding an abuse of a dominant position on the market, and provided the Court with an opportunity to further define the elements necessary for an enterprise to be in a dominant position and to be abusing that position. This article examines the extraterritorial extension of jurisdiction of EEC antitrust laws to non-Community enterprises and studies the evolution of the concept of "abuse of a dominant position" from its origins through the decision in *United Brands.*

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Denver Journal
OF INTERNATIONAL LAW AND POLICY

MYRES S. McDOUGAL DISTINGUISHED LECTURE

Global Human Rights: Challenges and Prospects

C. Clyde Ferguson*

This is the third annual Myres S. McDougal Distinguished Lecture in International Law and Policy presented at the University of Denver College of Law in the Spring of 1978. Sponsored by the International Legal Studies Program, the International Law Society, the DENVER JOURNAL OF INTERNATIONAL LAW AND POLICY, *and the Student Bar Association, the lecture series presents eminent jurists and scholars addressing significant issues of international law and policy.*

I have a particular pleasure in having the opportunity of speaking here tonight at this conference on human rights. There have been many such conferences recently, which I can only applaud, for I can remember the period, which you might call the Kissinger era, where the very subject of human rights was not one to be mentioned in polite company. My remarks tonight will be a lawyer's perspective on Global Human Rights—Challenges and Perspectives.

First, we might turn to the two basic theoretical problems in global human rights; and turn to them not so much because they are particularly interesting from a theoretical standpoint, but because they relate to the principal unfinished business of international human rights, which is effective implementation.

The first of these problems is simply whether or not there is a global basis for a consensus on human rights as appears,

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for example, in the Universal Declaration of Human Rights. What strikes one about the Declaration is its unparalleled proclamation that these are, in fact, universal rights which exist on a global leval and which, by implication, exist solely by virtue of fact that these rights attach to human beings simply because they are human.

One of the major theoretical difficulties in this field is whether or not there is a basis for universality. An academic colleague of mine has been looking for some years at the ethical and religious dimensions of human rights as they appear in the Universal Declaration and in some seventeen United Nations instruments. Searching for a commonality among the major religious systems in the world, she has unfortunately concluded, in a forthcoming book, that she can find no such common theme in the major religious systems that would serve as a consensual basis for the rights which are put forth in the Universal Declaration, in the covenants, and in other international human rights instruments. This finding is rather disheartening because it certainly runs counter to what we hear from the religious establishment, and to what we want to believe.

This conclusion, of course, may not be so dire a finding, for we rarely pay much attention to history; however, what is made of the past may be crucial. Therefore, the ethical basis of human rights might turn out to be of some use. The fact remains, however, that it is not easy to say that, on an ethical dimension, there exists uniformly around the world a global consensus which would support those declarations of rights included in the Universal Declaration and in other United Nations instruments.

There is a second, more critical problem which also has political overtones: the question of whether or not the very nature, form, and definition of these universal rights are essentially a reflection of the North Atlantic Basin (using the North Atlantic Basin in the sense to include not only the products of the Enlightenment, principally of Locke, but to include the doctrine of Marxism, which is also an emanation of the North Atlantic Basin, Western Europe, and North America). In other words, the very definition of these rights may be so culturally biased that it is impossible to find a consensual basis in other cultures and other philosophies that would make effective implementation possible.

From the lawyer's perspective, we look at international law as a system, as possibly the basis upon which the structure of internationally recognized and implemented rights might rest. Unfortunately, my own work in this field leads me to rather pessimistic conclusions. First, in terms of traditional international law, it appears certain that there is no global consensus which would support declarations of human rights.

In traditional international law, prior to the developments in the U.N. system, there existed some restricted areas of fundamental rights, limited though they may be to protection by a sovereign. For example, the whole passport system rests on the doctrine of one sovereign asking another, "Please do not do anything terrible to my citizen while he is in your territory." If you read a passport you will see that a vestige of this doctrine remains where the Secretary of State says, "To whom it may concern, please give protection to my citizen while he sojourns in your land:" that is, rudimentary recognition of an obligation but based on request. This system has now become very, very much subject to erosion—erosion mainly because of the United States' attempt to use a passport system to deal with protection of certain political interests. Thus, there are the prohibited countries: you cannot go to Cuba; you cannot go to Vietnam; you cannot go to Albania. This erosion of traditional international law has made this doctrine suspect in the rest of the world, for the doctrine has been twisted by those who issue passports to serve the political purpose of keeping citizens of one country from having any contact with citizens of another country who have different ideological views.

More critical has been the problem of protection of property. Out of the North Atlantic Basin, and principally based on Locke, property protection has been an essential element of the conception of basic human rights in the Western world. For example, Locke starts with the conception that a man owns property in himself and in his labor. An extension follows from this basic assumption to all of the rights and freedoms that were established during the Enlightment: the rights and freedoms that had so much to do with the formulation of the Declaration of Independence and the Bill of Rights.

The conception that the property of foreigners is protected by an international system, by an international regime of law, however, is under attack, especially from the Third World. This attack revolves around the disputes about permanent sovereignty over natural resources. The Third World has said that every state has permanent sovereignty over its own natural resources. The First World and the Second World agree, but there the agreement with the Third World ends. That is, the Third World says, "If we take ownership of our natural resources away from alien owners and nationalize it, or transfer it to citizens of our state, we will compensate you under domestic law." But the First World answers, "That cannot be. This property is protected; it is a right protected internationally, and international law says you have to give us prompt, adequate, and reasonable compensation for any taking. Consequently, you are violating a fundamental human right if you nationalize under domestic law."

The Third World, however, takes the position that there is no such international law, traditional or otherwise. First, they say that these rules grew up at a time when most of the Third World were not members of the international community; therefore, anything that they did not participate in making is not binding. Consequently, there is a rejection of the basis for an international consensus reflected in law for very rudimentary human rights, that is, one of property in one's person and out of one's person. Second, there is the argument that, in fact, international law is severely flawed. If you read any international law text published before 1940, the introductory paragraph will open by saying that international law is the distillation of practice among Christian sovereigns. Given the structure and nature of the world today, the objection to the substantive context of international law is that this law essentially represents the views of the North Atlantic Basin.

There was a doctrine which provided for protection of human rights in traditional international law called the Doctrine of Humanitarian Intervention. The theory was that if a sovereign so mistreated its citizens that it shocked the conscience of Christian sovereigns, every sovereign not only had a right, but had a duty to intervene to protect those subjects against tyranny. As formulated, it was obviously an enormous advance before the U.N. era in terms of minimum protection of basic human rights. But what happened? It is alleged that humanitarian intervention, in many cases, really masked intervention for economic and political reasons. For example, the French intervened in the Middle East, in what is now Syria and Lebanon, allegedly to protect Christian communities against oppression, harassment, and massive violations of fundamental human rights. It took almost a hundred years to get the French out.

Consequently, there has been a feeling in many quarters of the world that this distortion of the very substance and nature of what purports to be universal international law, again appears to be, upon examination, an emanation from the North Atlantic Basin. Therefore, to rely upon those doctrines of classic international law as a foundation for this new superstructure of rights generated by the United Nations is a reliance on false premises. This premise is a fundamental, theoretical problem of whether or not there is a basis for a global consensus on human rights. We do not find it in religion; we do not find it in traditional international law; we do not find it in the historical origins of the period of the Enlightenment. The problem is, what possible substitute exists for this lack of consensus (since as a lawyer one looks to a certain kind of consensus that would make effective implementation possible)?

Absent a global consensus, one might say that implementation of recognized international human rights may very well appear to be impossible. But, as I suggested earlier, the uses of history are many.

History is purposeful, and it would appear that what we say about the past, even though it may be inaccurate, may very well perform a useful function of legitimizing what we have now. We must look to another factor when we consider from a legal perspective the problem of whether or not there is indeed a consensus.

We have heard very much in the words of Ambassador Andrew Young of the problem of the rising tide of hope, which I think accurately describes what is happening in the world community in regard to human rights. But one must see this hope in a particular context: the rising tide of hope is the hope of people, not the hope of the sovereign entities we call nation states and governments. This distinction, however, exposes a very crucial problem: Our whole international system is based on relations among states. As late as 1946 the classic texts in international law stated that individuals have no place in international law; international law is what one sovereign talks about to another sovereign. Therefore, if we have a system in which one sovereign only talks to another sovereign about what they want, they obviously do not talk about what they are doing to their subjects. Thus, the rising tide of hope focuses on what is really one of the most hopeful signs in this whole field of internationally protected human rights, that is, in several areas, the sovereign is being bypassed. And for my mind, this is a very good development.

For example, the complaint procedures adopted by the United Nations, imperfect though they may be, recognized that human beings on this planet have a right to talk to someone in the international community—the U.N.—about the inequities perpetrated by their sovereign. This certainly has provided courage, for example, to Soviet citizens to complain about their sovereign and to American citizens to complain about their sovereign to the international community. This procedure is the beginning of something very, very new: It is the beginning of the recognition that an individual has certain inalienable rights, and that even his sovereign cannot forbid him from making a complaint — a startling revelation given the background of traditional international law and traditional international relations where the sovereigns could only talk to each other. The origin of this right is mainly the result of a particular factual situation, the problem of South Africa. What South Africa has contributed is the political will for sovereigns to break through these old boundaries, these old theoretical constructs.

The sovereigns, however, have not been passive. Opposition has shown up as resistance to the United Nations in its lawmaking function. This resistance can be seen historically; for example, the Western powers in the early years of the U.N. insisted that the Universal Declaration be merely a statement of goals and aspirations. Clearly, it was not to be international law but merely a recommendation to the nation states for the shaping of their policies. The erosion of this concept now has reached the point that most lawyers at least assert that the Universal Declaration is, in and of itself, international law. But, remember the resistance of all the sovereigns: the Soviet Union abstained on the Universal Declaration; Saudi Arabia abstained because they could not conceive of women having equal rights with men; the United States voted for the Declaration but made clear that it was only a statement of aspirations.

We have come, however, a long way in recognizing that there is an irreducible minimum of rights which attach to one as a human being, and that sovereigns do not have the power to derogate or to say that these rights are granted to them by virtue of their sovereignty. This conclusion, however, leads us to a number of technical problems. These problems inhere in the covenants and several other instruments in which there is an ascertainable tension between the claim of the sovereign as being the fountain of all rights and the claim of individuals that there are certain rights inherent in being human.

There is a second theoretical problem, relative to the organizing principle, in declaring the substance of these rights which are to attach to humans. This problem is sometimes phrased in terms of the principle of individuality against the authority of the state, that is, the problem of defining the rights of individuals as opposed to the rights of groups. We have seen this conflict historically. For example, the first serious international effort to deal with protecting rights on an international scale grew out of Wilson's fourteen points in which he dealt with the question of protection of minorities as one of the causes of war. On an international level, one protected the rights of people by looking to the group characteristic, and looking to the group characteristic required an understanding of a certain level of conduct pertaining to the group. A prime example is the Polish convention of 1919 in which rights were looked at in terms of group characteristics, as opposed to a second principle, that of individuality. This principle is embedded in the U.N. Charter.

The tensions generated by group-individual problems remain. For example, in the Convention on the Elimination of All Forms of Racial Discrimination (Race Convention), there is a theoretical inconsistency which demands concern for the individual and for the individual's protection from having his skin color or race used as a basis for disparate treatment; yet, in the center of the Race Convention is a provision which states that if one is a member of a group which has been subject to racial discrimination in the past, the government is obligated to take special measures in order to make reparation for that damage. This clause is a group characteristic.

Thus, in terms of organizing principles, we also have to return to the problem of the difference between civil and political rights, as they are specified in the Covenant and in the first twenty articles of the Universal Declaration, and the problem of economic, cultural, and social rights. The classic analysis, contributed mainly by political scientists, is that there are some inherent differences between these two classes of rights.

Civil and political rights classically have grown up as limitations on the power of sovereigns, limits on what a government can do or cannot do to you, but not in terms of bestowing a right on an individual because he is an individual. It reminds me, for example, of the formula by which my university confers J.D. degrees on our graduates. The president says to the graduate, "You are now qualified to go practice those wise restraints which make men free." This statement reflects the civil and political arenas. The president does not say to a graduate anything about being "now qualified to go advise the government on policies of allocation of economic resources, which might make society more equitable." Consequently, when we look to that linkage between economic rights and civil and political rights, the problem of the relationship between these two sets of rights is really not the crucial issue. Rather, the crucial issue is the relationship between both sets of rights, civil and political rights and economic, social, and cultural rights, as they appear in the covenants and in the demands for the new international economic order. If one examines these economic specifications, one finds that what split the United States from the Soviet Union in the era of the Cold War is reflected in the Universal Declaration: the first twenty articles are civil and political, while the next nine are economic, cultural, and social. Nonetheless, when one examines economic, social, and cultural rights, one finds that the drafters assumed that they were dealing with an industrial society. Every single one of these rights — from the most explicit, that is, the right to days off, the right to leisure, the right to paid vacations — indicates that the Declaration was talking about an industrial society. It was not talking about a subsistence society where a farmer knows nothing about days off. Therefore, what you are dealing with, really, is a distinction that those in the industrial world can argue about, relative to the conflict of East against West, without addressing the problems of 90% of the world's populations, which are in a subsistence economy. In this sense, the demands for the new international economic order, which is a blueprint for a new world order, become highly relevant to the question of human rights.

What kind of a global economic system is going to evolve that will make it possible to enjoy these particular rights? What is the world going to evolve into after this era of "Pax Americana"? Is there room within a global model for this North

Atlantic conception of rights which attach to humankind simply by being humankind? These being the theoretical problems, I would like to discuss some of the problems of strategy within this context, particularly as they relate to the Carter Administration.

First, the Administration certainly has put human rights on the global agenda. That, in and of itself, is a first step in moving eventually toward some system of implementation. For example, I examined every speech in the general debate of the past U.N. General Assembly looking for human rights and found, for the first time, that every speaker in the general debate devoted some time to human rights, even though many of them stated: "My country has no problems, but those others have a few human rights problems." Even to this extent, an enormous advance in putting human rights on the global agenda has been achieved.

However, one of the responses which greatly troubles me is the Administration's submission of four treaty conventions to the Senate for ratification: the two covenants on human rights, the Race Convention, and the Inter-American Convention. The problem is that lawyers have riddled them with reservations: "these are things we will not accept." Therefore, the conventions, as presented, are filled with the resurrection of discarded doctrines that were used a hundred years ago. For example, the so-called State-Federal Clause: "We are the United States but we are not Texas or Colorado, and therefore we cannot make them do anything; we will use our best efforts to tell them, please do not violate people's human rights, but you must recognize we are a federal system." I am greatly troubled by this attitude, primarily in terms of the credibility of the Administration.

To take one example of a reservation, there is an article in the political covenant which says you cannot undertake to execute pregnant women or people under eighteen. The United States reservation says that we reserve the right to impose capital punishment on pregnant women and people under eighteen in present or future law. Can you imagine the incredulity of someone reading this reservation and then saying, "We are promoting human rights?" The same thing is true throughout the other conventions. For example, the United States says we do not accept any obligations under the Race Convention, which is really a replication of the Civil Rights Act of 1965 (the reason being that some people who were drafting the Civil Rights Act of 1965 were also drafting the Race Convention). In technical lawyer's language, the Race Convention is not self-executing. To accept those obligations, then, Congress essentially has to re-pass the Civil Rights Bill. In other words, the Administration has stumbled into an incredibly disastrous position in terms of its credibility and its leadership in the world. In prior instances, there were challenges to Taiwan's ratification of the Conventions from the People's Republic of China; there were challenges to the Federal Republic of Germany's ratifications of the Conventions because they were extended to West Berlin. Now, the United States has put itself in the position that if it does ratify these Conventions, it is clear that the United States, the leader of human rights, is going to be challenged on the ratification on the basis of bad faith.

Another problem is the treaty-making power as a way of making domestic law in the United States under our Constitution. However, it seems that we leave ourselves open in this context because the United States and the Administration have put themselves into the position of saying that they will not take this route for the improvement of the human rights condition, which appears to be a remnant of the old Bricker Amendment days.

Finally, in terms of strategies, there is the problem of what to do about South Africa. Certainly, it is easy to describe conditions there in terms of massive, consistent, persistent patterns of gross, outrageous violations of human rights. Here, there is some disappointment in the Administration's handling of the South African situation.

Briefly, the first problem is the National Security Advisor who keeps pointing out that we are trying to settle Zimbabwe (Southern Rhodesia). Therefore, a constraint on our South African policy arises from the fact that we need South Africa's help to settle the Rhodesian question. This policy is not effective human rights leadership because the problem in southern Africa is really South Africa; and South Africa must be dealt with on its own terms. However, looking now to the real problem of effective implementation, we have already seen that the recognition of the right of an individual to file complaints with the U.N. system is beginning to erode. In the interim, until we achieve "Utopia," when in fact we might have international jurisdiction to deal with human rights violations such as we had at Nuremburg, perhaps the problem is an effective national implementation of these international rights. To its credit, the Carter Administration, under the leadership of Congress, has begun to fashion some effective national remedies for the violation of human rights: a necessary measure until there exists an international jurisdiction.

The problem is how, and what forces you use, to get nation states to react properly. Certainly, we could use the carrot and stick approach, as is being used in our aid legislation. We also should not overlook the problem of international publicity. We have seen some power there, even with the most recalcitrant of regimes. Once word reaches the people, you have created pressure on nation states to do something. Therefore, just the publication of information becomes crucial to implementation.

I will conclude by saying that obviously there are enormous problems, both theoretical and practical. Some lawyers fear that maybe we are on the way to world government, that sovereigns are no longer the be-all and the end-all. Nonetheless, looking back ten or fifteen years, there is an enormous basis to justify the feeling that this rising tide of hope in the world is indeed going to make a difference.

ARTICLES

The European Court of Justice Judgment in *United Brands*: Extraterritorial Jurisdiction and Abuse of Dominant Position

JOSEPH JUDE NORTON*

The objective of this article is to examine two legal aspects of the European Community antitrust system which are of growing concern to the multinational enterprise doing business in Western Europe: (1) extraterritorial extension of jurisdiction of Community antitrust laws, and (2) the notion of "abuse of a dominant position" under Article 86 of the Treaty of Rome.[1] The recent judgment of the European Court of Justice in *United Brands*,[2] along with other judgments of the Court and decisions of the European Commission will be used as a focal point for analysis.

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1. Treaty Establishing the European Economic Community, March 25, 1957, 298 U.N.T.S. 11 (effective Jan. 1, 1958) [hereinafter referred to as the Treaty of Rome]. In a strict sense the "European Community" is comprised of (i) the European Coal and Steel Community established in 1952, (ii) the European Economic Community (EEC or Common Market) established in 1958, and (iii) the European Atomic Energy Community (Euratom), also established in 1958. For purposes of this article, however, "European Community" will be synonymous with the EEC. At present the European Community is comprised of nine member states: the six original members (Belgium, France, Germany, Italy, Luxembourg, and the Netherlands) and the three acceding members as of 1973 (Denmark, Ireland, and the United Kingdom). For a consideration of the Community law in general, *see inter alia* E. STEIN, P. HAY & M. WAELBROECK, EUROPEAN COMMUNITY LAW AND INSTITUTIONS IN PERSPECTIVE (1976); H. SMITH & P. HERZOG, THE LAW OF THE EUROPEAN COMMUNITY: COMMENTARY ON THE EEC TREATY (5 vols. 1976); and A. CAMPBELL, COMMON MARKET LAW (1969) (3 vols. with annual supplements). For a general consideration of the impact of EEC laws on American business, *see inter alia* Norton, *Overview of European Community Law: A Primer for Business and Attorneys*, 29 SW. L. J. 347 (1975).

2. United Brands Co. and United Brands Continentaal BV v. Commission of the European Communities, [1978] 3 COMM. MKT. REP. (CCH) ¶ 8429. The judgment was a result of an appeal by United Brands Company from a prior decision by the European Commission, [1976] [1976-1978 Transfer Binder, New Developments] COMM. MKT. REP. (CCH) ¶ 9800.

I. BACKGROUND

A. *The Treaty of Rome*

During the past twenty years, the antitrust laws of the European Community have evolved, at least from the perspective of the multinational enterprise, into the primary system of antitrust regulation in Western Europe, being generally applicable (with certain limited exceptions) to all sectors of the Community economy, private or public.[3] While Community antitrust laws do not preclude the continuing existence and vitality of national counterparts (Germany's, for example),[4] the national authorities are precluded from acting when the Community has asserted its authority or when national rules serve objectives different from those of the Community.[5] One of the fundamental objectives of the Community, as embraced by the Treaty of Rome, is "the institution of a system ensuring that competition in the common market is not distorted."[6] This system is an integral key to the overall objective of "establishing a common market and progressively approximating the economic policies of Member States."[7] In any event, whether in antitrust matters or otherwise, where there is a conflict between Community and national rules, the Community rules shall prevail.[8]

3. *See generally* W. ALEXANDER, EEC RULES OF COMPETITION (1973); C. BELLAMY & G. CHILD, COMMON MARKET LAW OF COMPETITION (2d ed. 1978); J. BAROUNOS, D. F. HALL & J. R. JAMES, EEC ANTI-TRUST LAW (1975); J. CUNNINGHAM, THE COMPETITION LAW OF THE EEC, A PRACTICAL GUIDE (1973) (with supplement); A. DERINGER, THE COMPETITION LAW OF THE EUROPEAN ECONOMIC COMMUNITY (1968); EEC COMMISSION, PRACTICAL GUIDE OF THE COMMISSION, ARTICLES 85 AND 86 OF THE EEC TREATY AND RELEVANT REGULATIONS: A MANUAL FOR FIRMS (1962); and C. OBERDORFER, A. GLEISH & M. HIRSCH, COMMON MARKET CARTEL LAW (2d ed. 1971).

4. For a discussion of national antitrust laws within the EEC, particularly respecting dominant positions, *see* REGULATING THE BEHAVIOR OF MONOPOLIES AND DOMINANT UNDERTAKINGS IN COMMUNITY LAW (J. A. van Damme ed. 1977). For statutory laws of each Member State, *see* O.E.C.D., GUIDE TO LEGISLATION ON RESTRICTIVE BUSINESS PRACTICES (4 vols. 1970).

5. *See* Wilhelm v. Bundeskartellemt, [1969] [1967-1970 Transfer Binder] COMM. MKT. REP. (CCH) ¶ 8056.

6. Treaty of Rome, Art. 3(f).

7. *Id.*, art. 2.

8. For a classic statement on the nature of Community law, *see* Costa v. ENEL, [1964] [1961-1965 Transfer Binder] COMM. MKT. REP. (CCH) ¶ 8023, at 7390. Also, *see generally* Bebr, *How Supreme is Community Law in the National Courts*, 11 COMM. MKT. L. REV. 3 (1974); Bebr, *Law of the European Communities and Municipal Law*, 34 MOD. L. REV. 481 (1971); and Warner, *Relationship between European Community Law and the National Laws of Member States*, 93 LAW Q. REV. 349 (1977).

The main prohibitions of Community antitrust laws are contained in Articles 85 and 86 of the Treaty of Rome,[9] both of which are directly applicable (*i.e.*, fully self-executing) within the Member States.[10] Article 85 prohibits "all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition" within the Community.[11] Article 86 expressly prohibits any abuse by one or more undertakings of a dominant position within the Community or in a substantial part of it.[12] Activities violative of

9. The provisions of the Treaty of Rome dealing with antitrust matters are articles 85-94. Briefly, article 85 pertains to restrictive trade practices; article 86 to abuses of a dominant position; articles 87-89 to the implementation of articles 85 and 86; article 90 to rules concerning public enterprises; article 91 to transitional antidumping rules; and articles 92-94 to rules on state aids.

10. The significance of a Community provision being self-executing is that such provision is automatically incorporated into the national legal order (*i.e.*, it becomes part of the law of the land) without further intervention of law or of any governmental authority: thus legal rights and obligations under Community law (which could give rise to individual claims before national courts) are directly created within the national legal order. *See generally* Bebr, *Directly Applicable Provisions of Community Law: the Development of a Community Concept*, 19 INT'L & COMP. L. Q. 257 (1970); and Winter, *Direct Applicability and Direct Effect—Two Distinct and Different Concepts in Community Law*, 9 COMM. MKT. L. REV. 425 (1972).

11. Article 85(1) contains certain illustrative, but not exhaustive, examples of particular restrictive trade activities which would be incompatible with the establishment of a common market, if the general requirements of article 85(1) are met, especially those activities which:

> (a) directly or indirectly fix purchase or selling prices or any other trading conditions;
>
> (b) limit or control production, markets, technical development, or investment;
>
> (c) share markets or sources of supplies;
>
> (d) apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;
>
> (e) make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such agreements.

12. Article 86, which will be the primary concern of this study, reads as follows:

> Any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it shall be prohibited as incompatible with the common market in so far as it may affect trade between Member States. Such abuse may, in particular, consist in:
>
> (a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions;
>
> (b) limiting production, markets or technical development to the prejudice of consumers;

article 85, which are not subject to a discretionary exemption from the European Commission, are automatically void.[13] Activities violative of article 86 are absolutely null and void without exception.[14]

Council of Ministers Regulation 17 outlines the procedure for implementing and enforcing articles 85 and 86 by essentially providing for an administrative process whereby the European Commission is granted wide discretion to investigate and determine violations or to grant or deny negative clearances and specific exemptions under article 85.[15] While the rules of civil procedure in a relevant Member State determine the ultimate enforcement procedure of a Commission decision,[16] the Commission possesses the power to sanction an offending undertaking by requiring the termination of the illegal activity. It can also exact fines for specific violations and periodic penalty payments for continuing violations.[17] Thus, the Commission can be viewed as both the primary interpreter and enforcer of the Community antitrust rules. The Court of Justice, however, retains the ultimate and unlimited power of review, both with respect to the legal interpretation of such rules and to the propriety of Commission antitrust decisions.[18]

The American observer of the Community antitrust system may be quick to conclude that the drafters of Community antitrust laws are undoubtedly astute students of the American counterpart.[19] Nevertheless, a flippant comparison of the two

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(c) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;

(d) making the conclusion of contracts subject to acceptance by other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

13. Treaty of Rome, Art. 85(2). Under article 85(3) the Commission is granted discretionary authority through the use of a balancing test of good and bad effects to grant specific or group exemptions for activities otherwise violative of article 85(1).

14. *Id.*, art. 86.

15. EEC Council of Ministers Regulation 17/62, 1 COMM. MKT. REP. (CCH) ¶ 2401 *et seq.* [hereinafter referred to as Regulation 17].

16. *Id.*, art. 15, at ¶ 2542.

17. *Id.*, art. 3, at ¶ 2422, and art. 16, at ¶ 2551; *see generally* Graupner, *Commission Decisionmaking on Competition Questions*, 10 COMM. MKT. L. REV. 291 (1973).

18. Treaty of Rome, Art. 172; and Regulation 17, art. 9, at ¶ 2482, and art. 17, at ¶ 2561.

19. For a comparison of EEC and U.S. antitrust laws, *see inter alia* COMMON

antitrust systems is fraught with danger, as both systems must be analysed within the context of their own respective milieu. For example, the historical and economic conditions which gave birth to the Community laws are wholly different from those which inspired the Sherman and Clayton Acts. In its formation, the Community was confronted with two major dilemmas: first, the attainment of the capacity to achieve economies of scale conducive to European industrial and commercial growth, and second, the amalgamation of the separate economies of the Member States to the extent necessary to form a unified common market. Accordingly, Community law and practice have shown no built-in reflex against size or against large "European" business combinations (cartels). Quite the contrary, Community practice has actively encouraged mergers, combinations, and cooperative groupings of genuinely "European" firms, particularly those of small and medium size, which are conducive to overall economic growth.[20] However, where such activities have been deemed to run counter to the basic objectives of the Treaty of Rome, the Commission has been most vigorous in enforcing Community antitrust laws.[21]

Prior to 1970, Article 86 was a dormant provision of the Treaty of Rome, discussed by academics, but neglected by the European Commission and Court of Justice.[22] It was not until the Commission's decision in *Continental Can* in 1971,[23] and the Court of Justice's landmark judgment in this case in 1973,[24] that the legal potential of article 86 to attack mergers and acquisitions became apparent. Since 1973, there has been a

MARKET AND AMERICAN ANTITRUST, OVERLAP AND CONFLICT (J. A. Rahl ed. 1970); A. CROTTI, TRADING UNDER EEC AND U.S. ANTITRUST LAWS (1977); and Jones, *American Antitrust and EEC Competition Law in Comparative Perspective,* 90 LAW Q. REV. 191 (1974).

20. For a discussion of the economic objective behind the Community antitrust system, *see* D. MCLACHLAN & D. SWANN, COMPETITION POLICY IN THE EUROPEAN COMMUNITY (1967); and D. SWANN & D. LEES, ANTITRUST POLICY IN EUROPE (1973).

21. *See generally* EUROPEAN COMMISSION, REPORT ON COMPETITION POLICY, which has been published annually since 1972.

22. Prior to 1970, the Commission had not instituted proceedings under article 86.

23. For the Commission decision in *Continental Can,* see *U.S. Container Firm Held to Violate Antitrust Rules* [1971] [1970-1972 Transfer Binder, New Developments] COMM. MKT. REP. (CCH) ¶ 9481.

24. Europemballage Corp. and Continental Can Co. v. Commission of the European Communities, [1973] [1971-1973 Transfer Binder] COMM. MKT. REP. (CCH) ¶ 8171.

series of decisions and judgments (the latest of which is *United Brands*) which have endeavored to put legal meat on the bare bones of article 86, although the Commission and Court of Justice have not always seen eye to eye on the matter. These decisions and judgments, many of which involve American-related multinationals, will be considered.

B. *Extraterritorial Extension of Jurisdiction*

Extraterritorial extension of antitrust laws by administrative and judicial organs has been increasing recently.[25] Of particular note are the jurisdictional claims of the European Community. This matter is of concern to the U.S. multinational from several perspectives. First, there is the aspect of direct economic activity within the Community through subsidiaries and branches; second, there is the aspect of multinational activity outside the Community which may be deemed to have an effect within the Community.[26]

Traditionally, one of the basic principles for determining jurisdiction is the territorial principle, which makes reference to the place where the offense is committed.[27] Over the years, however, the territorial principle has been expanded by various jurisdictions. First, the so-called subjective territorial principle has been developed to establish the jurisdiction of a state and its judicial organs to prosecute and punish offenses commenced within the state and completed abroad. Second, the objective territorial principle has been established, which gives jurisdiction to a state and its judicial organs to prosecute an offense commenced outside the state but consummated within its territory.[28] For example, under U.S. practice the objective territorial principle has been expanded to cover "conduct that occurs outside its territory and causes an effect within its territory," if such conduct is a constituent element of the offense, is "substantial," is "a direct and foreseeable result of the con-

25. *See* Yazawa, *Extraterritorial Application of Antitrust and Securities Laws*, to be published in RECEUIL DES COURS (Hague 1976); and Kronstein, *Conflicts Resulting from the Extraterritorial Effects of the Antitrust Legislation of Different Countries*, XXTH CENTURY COMPARATIVE AND CONFLICTS LAW 432 (K. Nadelmann *et al.*, eds. 1961).

26. *See inter alia* Allen, *The Development of European Economic Community Antitrust Jurisdiction Over Alien Undertakings*, 2 LEGAL ISSUES OF EUROPEAN INTEGRATION 35 (1974); and Goldman, *Les effets juridiques extraterritoriaux de la politique de la concurrence*, 1972 REV. MARCHÉ COMMUN 612 (1972).

27. *See* Harvard Research Study in International Law, *Jurisdiction With Respect to Crimes*, 29 AM. J. INT'L L. SUPP. 435, 439 (1935).

28. *See* BRIERLY, THE LAW OF NATIONS, 299-304 (6th ed. 1963).

duct outside the territory," and is not "inconsistent with the principles of justice generally recognized by states that have reasonably developed legal systems."[29] This exposition of the so-called "effects" doctrine of territorial jurisdiction has developed considerable controversy in international legal circles,[30] and has been the subject of heated discussion within the Community.[31] The question of extraterritorial jurisdiction as it has been developed by the Court of Justice in cases before *United Brands* will be discussed.

C. *The United Brands Case*

For present purposes, a factual background to *United Brands* is needed for a better understanding of the matters to be discussed. The United Brands Company (UBC), a New Jersey corporation, came into existence in 1970 through the merger of the United Food Company and the American Seal Kap Corporation. UBC represents the largest group on the world banana market and had been successful at maintaining somewhere between a 40-45% share of the relevant EEC market. UBC parents a European subsidiary, United Brands Continentaal BV (Continentaal), which maintains a registered office in Rotterdam, and which is responsible for coordinating banana sales in all Community Member States, except the United Kingdom and Italy (where separate affiliates Fyffes and C.I.F. operate). UBC maintains a highly vertically-integrated operation, owning vast banana plantation acreage. It maintains one of the world's largest banana boat fleets (including refrigerator ships), and operates ripening facilities in many of its importing countries. It also controls an elaborate distribution system of banana imports throughout the world (including the EEC), marketing its bananas through a common sales policy, and organizing and paying for advertising and sales promotion itself under the "Chiquita Banana" label. Only bananas satisfying certain quality standards are permitted to bear the Chiquita label; however, these products are sold at a price 30-

29. AMERICAN LAW INSTITUTE, RESTATEMENT OF THE LAW, SECOND, FOREIGN RELATIONS OF THE UNITED STATES, § 18 (1965).

30. *See, e.g.*, AMERICAN SOCIETY OF INTERNATIONAL LAW, PROCEEDINGS, 1962, at 18-43; 1964, at 124-54; 1972, at 14-22; 1974, at 250-65; and Mann, *Anglo-American Conflict of International Jurisdiction*, 13 INT'L & COMP. L. Q. 1460 (1964).

31. Harding, *Jurisdiction in EEC Competition Law: Some Recent Developments*, 11 J. WORLD TRADE L. 422 (1977); and Jacquemin, *Application to Foreign Firms of European Rules of Competition*, 19 ANTITRUST BULL. 157 (1974).

40% above that of unbranded bananas. Despite this price differential, UBC sales at the time of the Commission's investigation accounted for 40% of total banana sales in the Netherlands, 50% in Belgium and Luxembourg, 45% in Germany and Denmark, over 40% in the United Kingdom (through its Fyffes subsidiary), 40% in Italy (through its Italian subsidiary, C.I.F.), 20% in France, and 25% in Ireland. UBC's main worldwide and EEC competitors, Castle & Cook Company and Del Monte Company (both American corporations), could only account for 9% and 5% respectively of the total EEC market.[32]

UBC fixed prices weekly, and these prices appeared to vary significantly from country to country within the Community. For example, the average maximum weekly difference between Germany, the Benelux countries, and Denmark was 13.5% in 1974, with differences being even greater between these countries and Ireland, where UBC had only recently penetrated the market. With respect to conditions of sales to distributor/ripeners, UBC imposed prohibition on resale of UBC bananas to competing ripeners, on the resale of green bananas, and on the sale of non-UBC bananas. In addition, UBC dealers in one country were not permitted to sell bananas to dealers in other countries, which, according to the Commission, led to a segregation of markets within the Community.

In 1969, UBC's second largest distributor/ripener in Denmark, Olesen, acquired the exclusive distributorship for "Dole" (the trade name for Castle & Cook) bananas in Denmark. It then appeared that UBC began undersupplying the orders placed by Olesen. In particular, in 1973, when Castle & Cook embarked upon a major sales promotion campaign in Denmark, UBC notified Olesen that it was discontinuing supplies of Chiquita bananas altogether. Olesen then endeavored to obtain products from other Danish and German customers of UBC, but was unable to acquire any green bananas for ripening from these sources. In February 1974, Olesen submitted a complaint to the Commission; however, in February 1975, an agreement was reached between Olesen and UBC, with supplies to Olesen being resumed. Olesen withdrew its complaint to the Commission in March 1975. In May 1974, certain Irish

32. For background information regarding United Brands Co. see Litvak & Maule, *Transnational Corporations and Vertical Integration: The Banana Case*, 11 J. WORLD TRADE L. 537 (1977).

petitioners also submitted an application to the Commission complaining of UBC activities.[33]

On March 19, 1975, six days after the Olesen complaint was withdrawn, the Commission initiated proceedings against UBC on the basis that UBC was engaging in abuse of its dominant position. After an administrative hearing on the matter, the Commission, on December 17, 1975, decided that UBC had in fact infringed Article 86 of the Treaty of Rome.[34] As a consequence of this violation, the Commission assessed a fine of one million units of account against UBC. UBC appealed to the Court of Justice to set aside the Commission's decision and to order the Commission to pay UBC moral damages in the amount of one unit of account, and in the alternative, if the decision be upheld, cancel or at least reduce the fine.[35]

On February 14, 1978, the Court of Justice rendered its judgment in the case by:

(i) annulling that part of the Commission's decision which found that UBC had imposed unfair prices for the sale of its bananas;

(ii) reducing the amount of the fine to 850,000 units of account;

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33. For a general discussion of the facts, see [1976-1978 Transfer Binder, New Developments] COMM. MKT. REP. (CCH) ¶ 9800, at 9775-85.

34. The Commission based its conclusion on the findings that UBC:

(i) required its distributor/ripeners not to sell green bananas;

(ii) charged its distributor/ripeners in various Member States prices which differed considerably, without any objective justification, for bananas of the same quality, even though the conditions of the market were to all intents and purposes the same;

(iii) applied differing prices to its distributor/ripeners, the difference sometimes amounting to 138%; and

(iv) refused to supply Chiquita brand bananas to Olesen on the ground that Olesen had taken part in an advertising campaign for bananas of a competing brand.
Id. at 9785-92.

35. UBC based its appeal on the following contentions:

(i) it challenged the Commission's finding and analysis of the relevant market, the product market, and the geographic market;

(ii) it denied that it was in a dominant position within the Community for purposes of article 86;

(iii) it considered the clause related to the conditions of sales of green bananas to be justified in order to safeguard the quality of the product sold to the consumer;

(iv) it purported to show that the refusal to continue to supply Olesen was justified;

(v) it asserted that it had not charged discriminatory prices, nor that the prices charged were unfair; and

(vi) it complained that the Commission's administrative procedure was irregular.
3 COMM. MKT. REP. (CCH) ¶ 8429, at 7704.

(iii) dismissing the rest of UBC's application; and

(iv) ordering each party to bear its own cost.[36]

A discussion of the merits of the case will be made subsequently in this article.

II. EXTRATERRITORIAL JURISDICTION

What is significant about *United Brands* and the question of extraterritorial jurisdiction is that neither UBC nor the Court of Justice ever raised the issue. This silence, in this writer's view, indicates that, at least for the moment, the Commission and the Court have struck upon a common approach to which plaintiffs, such as UBC, will acquiesce. The underpinnings for this approach are derived from earlier jurisprudence of the Court.

A. *The ICI Case: The Search for a Noncontroversial Theory*

The references in Articles 85 and 86 of the Treaty of Rome with respect to "effect" upon trade between Member States or within the Common Market provide a literal basis for exposition of an "effects" doctrine respecting extraterritorial extension of subject matter jurisdiction by the European Community in antitrust cases. The Commission has been quite amenable to expound such a theory of extraterritorial jurisdiction and from an early stage has made clear that "the fact that several or all of the undertakings involved have their principle head offices outside the Community is no obstacle to the application of this rule insofar as the agreements, decisions or concerted practices have effects extending to the Common Market."[37] The Commission took solace in earlier language of the Court of Justice in its 1971 judgment in *Béguelin* (which language was not critical to the outcome of the case), wherein the Court gratuitously noted that "the fact that one of the enterprises participating in an agreement is located in a third country does not prevent the appliction of Article 85 . . . where the effects of the agreement extend to the territory of the Common Market."[38] However, as will be seen, the Court of Justice has

36. *Id.* at 7721-22.

37. European Commission, *Opinion relating to imports into the Community of Japanese products covered by the Treaty of Rome,* C111 OFFICIAL J. EUR. ECON. COMMUNITY 13 (Nov. 21, 1972).

38. Béguelin Import Co. v. G. L. Import Export [1972] [1971-1973 Transfer Binder] COMM. MKT. REP. (CCH) ¶ 8149, at 7697.

been reluctant to date to espouse explicitly the "effects" concept.

The 1972 decision of the Court of Justice concerning Imperial Chemical Industries of Great Britain (ICI) was the first clear exposition by the Court of its views on the extraterritorial applicability of Community antitrust laws.[39] One of the main issues in this case was the extent of the Commission's authority to fine a non-EEC enterprise for alleged violations of Community antitrust law. ICI, which at the time of the suit was a non-Community enterprise, had been fined in 1969 by the Commission, along with nine other dye stuff manufacturers, pursuant to article 85(1) for price fixing. ICI challenged the EEC's jurisdiction to impose such fines merely because of the effect produced in the EEC by acts it may have committed outside the Community. ICI further asserted before the Court of Justice that the acts in question, which may have been committed within the Community, were those of its subsidiary within the Community and not the parent company.

The Commission in its 1969 decision in *ICI* stated:

> In view of these circumstances, there is no doubt that the price increases which the Commission found had taken place are at least the result of concerted practices within the meaning of Article 85, paragraph 1. There is therefore no need to examine whether these price increases are the result of an agreement.[40]

The Commission avoided proof that the effects were a direct and causal offshoot of the concerted practices in question, that is, whether the concerted practices were "an essential constituent element of the offense" as is traditionally required by the objective territorial principle. While the facts of the case appear to indicate that there were concrete effects occurring within the EEC which were traceable to the concerted practices in question, the Commission apparently wished to avoid meeting this burden of proof.[41]

The Commission's decision was sharply criticized for a variety of reasons. First, the exposition of the effects doctrine by the Commission has been characterized as lacking the limi-

39. Imperial Chemical Industries, Ltd. v. Commission of the European Communities [1972] [1971-1973 Transfer Binder] COMM. MKT. REP. (CCH) ¶ 8161.

40. *Commission Rules Against Dyestuff Manufacturers* [1969] [1965-1969 Transfer Binder, New Developments] COMM. MKT. REP. (CCH) ¶ 9314, at 8691.

41. *See* Allen, *supra* note 26, at 51.

tations required by international law under the objective territorial principle.[42] Moreover, one writer has questioned whether or not the Treaty of Rome establishing the EEC could have a binding effect upon nonsignatory states and their nationals.[43] The answer to this latter question depends entirely upon the legal status of the EEC itself.

From the point of view of the Court of Justice, the EEC is not analogous to an international organization but constitutes a separate, distinct, and autonomous legal order in and of itself.[44] This concept of the Community legal order provides the basis for the Commission's actions.[45]

On appeal before the Court of Justice, however, the Commission offered the Court an alternative argument to support jurisdiction. This alternative argument was based on the fact that ICI as well as certain other foreign firms had acted within the EEC inasmuch as the foreign parent and its EEC subsidiaries were a "single enterprise" and as such, acts of a subsidiary could be imputed as actions of the foreign parent. The offering of this alternative, which ironically had previously been used to exclude activities between a parent and its subsidiaries from the Community antitrust laws,[46] appears to have been made on strategic grounds, perhaps based on a fear by the Commission that the "effects" concept might be rejected by the Court of Justice, particularly since this concept was not well received among European legal experts.[47]

42. Steindorff, *Annotation on the Decisions of the European Court in the Dyestuff Cases of July 14, 1972*, 9 COMM. MKT. L. REV. 502 (1972).

43. Mann, *The Dyestuffs Cases in the Court of Justice of the European Communities*, 22 INT'L & COMP. L. Q. 35 (1973).

44. [1961-1965 Transfer Binder] COMM. MKT. REP. (CCH) ¶ 8023, at 7390.

45. The rules of competition of the Treaty are therefore applicable to all restrictions of competition that produce within the Common Market effects to which Article 85, paragraph 1, applies. There is therefore no need to examine whether the enterprises that originated such restraints of competition have their head office within or outside of the Community.

[1965-1969 Transfer Binder, New Developments] COMM. MKT. REP. (CCH) ¶ 9314, at 8694.

46. *See* Commission Decision, *Relating to a Request for Negative Clearance* (Christiani & Nielsen), [1965-1969 Transfer Binder, New Developments] COMM. MKT. REP ¶ 9308, in which a genuine parent-subsidiary relationship was held to preclude the application of EEC antitrust laws to the intracorporate activities of the two corporations.

47. *See* Allen, *supra* note 26, at 53.

The most lucid exposition in this case of the "effects" concept in light of the objective territorial doctrine was made in the submissions of the Advocate General to the Court.[48] The Advocate General submitted a persuasive argument in favor of the "effects" concept, his position being grounded on the following reasoning:

(i) Article 85 presents as criteria the anticompetitive effect in the EEC, without taking into account either the nationality or the locality of the headquarters of the undertaking responsible for the breaches of competition;

(ii) The statutes and case law of the Member States of the EEC prohibit or penalize interference with competition, the effects of which are produced on a territory, "irrespective of the nationality or place of residence of the infringer;"

(iii) As to nonmembers of the EEC, the acceptance of the "effects" doctrine is recognized in statutes and laws of such countries as the United States, the United Kingdom, and Switzerland, the Advocate General placing particular emphasis upon American case law and the *U.S. Restatement on Foreign Relations;* and

(iv) According to both EEC and international law, the Community, as constituting a separate legal order, has the same powers as a state to apply its competition laws to undertakings, even if foreign to the EEC.[49]

The ultimate conclusions reached by the Advocate General approximate those contained in Section 18(b) of the *Restatement:* the concerted practices in question must cause a direct and immediate restriction within the EEC and must be of a foreseeable character with substantial effect.[50] In addition, the Advocate General suggested that the effect of the infringement would be one of its constitutive elements and probably even the essential element. The Advocate General did concede that, while the EEC does have subject matter jurisdiction, the Community would not have executory or enforcement jurisdiction inasmuch as the Commission would not be entitled to take coercive measures against the foreign undertakings within ter-

48. For the function of the Advocate General, see Treaty of Rome, Art. 166.

49. Discussion of Advocate General Mayras, [1971-1973 Transfer Binder] COMM. MKT. REP. ¶ 8161, at 8049-58.

50. Note 29 *supra*.

ritory where the EEC could assert no authority.[51]

In spite of the lengthy debate of the "effects" doctrine, the Court of Justice, in reaching its decision, made no reference to the Advocate General's submissions, but instead accepted the Commission's alternative basis of jurisdiction (*i.e.*, the single enterprise theory).[52] On the basis of the facts, particularly that binding telex instructions had been sent by ICI to its subsidiary and that ICI held all, or at least a majority of, its subsidiary's stock, the Court concluded that ICI and its subsidiaries constituted a single economic unit.[53] This single enterprise theory appears to be an aberrant version of the corporate law "alter ego" concept, which hinges not on legal criteria, but on economic considerations.[54]

Although circumventing the "effects" doctrine, the Court reached the same conclusion with its single enterprise doctrine. Moreover, the Court avoided major international reactions against a broad extension of the extraterritorial jurisdiction doctrines. The Court did not, however, reject the "effects" doctrine: it never formally considered it.

B. *From "Continental Can" to "United Brands"*

The European Commission, apparently sensing that it was not worth the battle to press the "effects" doctrine when the single enterprise doctrine would suffice, primarily applied this latter theory in its 1971 *Continental Can* decision.[55] For pur-

51. [1971-1973 Transfer Binder] COMM. MKT. REP. ¶ 8161, at 8056.

52. *Id.* at 8031.

> If the subsidiary does not in fact have autonomy in determining its course of conduct on the market, the prohibition of Article 85, paragraph 1, is inapplicable to the relationship between it and the parent company, with which it forms an economic unity. Since an affiliated group so structured forms a unity, the parent company can, under certain circumstances, be held responsible for the actions of the subsidiary. . . . Under these circumstances, the separation between parent firm and subsidiaries arising out of the fact that each has a distinct legal personality does not prevent their conduct on the market from being viewed as a unity for purposes of the application of the rules of competition. For this reason, it is the plaintiff that brought about the concerted practice within the Common Market.

53. Griffin, *The Power of Host Countries Over the Multinational: Lifting the Veil in the European Economic Community and the United States*, 6 L. & POL'Y INT'L BUS. 375 (1974).

54. For further discussion of the case, see Acevedo, *The EEC Dyestuffs Case: Territorial Jurisdiction*, 36 MOD. L. REV. 317 (1973); and Mann, note 43 *supra*.

55. For the Court of Justice decision, see [1971-1973 Transfer Binder] COMM. MKT. REP. (CCH) ¶ 8171; for the Commission decision, see [1970-1972 Transfer

poses of finding jurisdiction, the Commission spent little time analyzing the facts and concluded that, primarily because of stock ownership, Continental Can controlled its subsidiary, Europemballage, and accordingly, the behavior of the subsidiary could be imputed to the parent. The Advocate General provided further elaboration by noting that Continental Can's subsidiary did not display any autonomous behavior, nor did it have any economic independence. This conclusion was drawn partly from the fact that the funds for the acquisition of a Dutch corporation were made available by Continental Can. At the time that Continental Can caused Europemballage to make an offer to purchase, the latter company was still not fully organized.[56] Moreover, the Advocate General justified jurisdiction on both the subjective and objective territorial principles, since certain conduct (*i.e.*, the consummation of the acquisition) had occurred within the EEC and the acts of the enterprises involved had effects within the EEC. While affirming the single enterprise theory, the Court did use further language which would appear to indicate that even if Continental Can did not have a "controlled" EEC subsidiary, jurisdiction could have been exercised.[57]

In its 1972 decision against Commercial Solvents Corporation (CSC),[58] another U.S. corporation, the Commission again

Binder, New Developments] COMM. MKT. REP. (CCH) ¶ 9481.

56. [1971-1973 Transfer Binder] COMM. MKT. REP. (CCH) ¶ 8171, at 8284-85.

57. *Id.* at 8298.

> Plaintiffs cannot deny that Europemballage, which was formed by Continental on February 20, 1970, is a subsidiary of Continental. The fact that the subsidiary has its own legal personality is not sufficient to rule out the possibility that its conduct can be imputed to the parent company. This applies particularly where the subsidiary does not determine its market conduct autonomously but in the main follows the instructions of the parent company. . . . Such an acquisition, which affects market conditions within the Community, is the type to which Community law applies. The fact that Continental does not have its seat in the territory of one of the Member States is not sufficient to remove this enterprise from the application of Community law.

For further discussion of the case, see *inter alia*, Chandelle, *Common Market—Antitrust—Use of Article 86 to Invalidate Mergers*, 15 HARV. INT'L L. J. 333 (1974); Hurwitz, *The Impact of the Continental Can Case on Combinations and Concentrations Within the Common Market*, 25 HASTINGS L. J. 469 (1974); Singley, *Abuse of a Dominant Position by Acquisition in the Common Market: The Continental Can Cases*, 12 COLUM. J. TRANSNAT'L L. 359 (1973); and Haubert, *Continental Can—New Strength for Common Market Anti-Trust*, 11 SAN DIEGO L. REV. 227 (1973).

58. *Commercial Solvents Corporation Fine Announced*, [1973-1975 Transfer Binder, New Developments] COMM. MKT. REP. (CCH) ¶ 9543.

based its decision on the single enterprise theory. The Commission relied upon the definition of controlled companies under Italian company law and the fact that in its annual report the Italian subsidiary was listed as belonging to CSC. The Commission apparently did not feel entirely comfortable with its basis for linking CSC and its Italian subsidiary as one entity.[59] The twist in this case was that the Commission imputed the liability of the parent to that of the subsidiary, which seems to contradict the "nonautonomous behavior" test for the subsidiary.

On appeal to the Court of Justice, the Commission emphasized that CSC controlled its Italian subsidiary, "at least as regards its relation with complainant."[60] This emphasis appears to modify the single enterprise doctrine, requiring proof relating to the single conduct in question, and not with respect to the general activities of the parent and subsidiary. In *Commercial Solvents*, the Advocate General attempted to broaden even further the single enterprise theory by asserting that:

> there is a presumption that a subsidiary will act in accordance with the wishes of its parent, because according to common experience subsidiaries generally do so act; . . . that unless that presumption is rebutted, it is proper for the parent and the subsidiary to be treated as a single undertaking for the purposes of Articles 85 and 86 of the EEC Treaty; and that the presumption can be rebutted only if it is shown affirmatively, by those concerned to rebut it, that the subsidiary in fact conducted its business autonomously.[61]

Such a presumption appears to place an insurmountable burden upon the defending parent and subsidiary corporations and runs contrary to the traditional corporate law presumption that related corporate entities are separate and distinct by virtue of their respective corporate personalities.

59. *Id.* at 9215-5.

> CSC holds the power of control over ICI [its Italian subsidiary] and does, in fact, exercise that power, at least as far as relations with Zoja [complainant corporation] are concerned in such a way that no distinction can be made between the will and the actions of CSC and those of ICI. The CSC and ICI companies must, therefore, be treated as forming . . . a single undertaking or economic unit.

60. It should be noted that the Commission also, secondarily, relied on the "effects" doctrine.

61. Istituto Chemioterapico Italiano S.p.A. and Commercial Solvents Corp. v. Commission of the European Communities [1974] [1974 Transfer Binder] COMM. MKT. REP. (CCH) ¶ 8209, at 8827.

As in *ICI* and *Continental Can,* the Court of Justice in *Commercial Solvents* avoided any discussion of the "effects" doctrine. The Court held that the conduct of CSC and its Italian subsidiary constituted a "united action" responsible for the conduct complained of, and that the "entity" needed to be proved only with regard to CSC and its subsidiary's relationship with the complainant. This assertion approximates the Commission's position; however, the Court of Justice provided no objective test for determining what constitutes a "united action."[62]

The Commission has again recently applied the single enterprise doctrine in its decision against Hoffman-LaRoche (LaRoche), the Swiss pharmaceutical company, for abuse of its dominant position in the EEC as a supplier of vitamins.[63] By a fleeting reference, the Commission promptly based its jurisdiction on the fact that LaRoche had various subsidiaries within the Community, through which LaRoche could be considered to have acted.

As indicated above, in its 1975 decision against UBC, the Commission imposed a fine of one million units of account against UBC for the abuse of dominant position that it holds in the banana market within the EEC.[64] Because UBC is a highly integrated corporation whose operations are directed by a central board of directors in New York, the Commission concluded that the EEC subsidiaries did not possess any real autonomy, but formed a single economic unit with UBC. The facts in this case were perhaps the strongest of all preceding cases in justifying the assertion of the single enterprise concept. Moreover, unlike *Commercial Solvents,* the Commission decision held only the parent company liable.[65]

III. ABUSE OF A DOMINANT POSITION

In its 1968 judgment in *Parke Davis,* the Court of Justice

62. For further discussion of the case, see Korah, *Istituto Chemioterapico Italiano S.p.A. and Commercial Solvents Corporation v. Commission of the European Communities,* 11 COMM. MKT. L. REV. 248 (1974).

63. *Vitamin Maker Fined for Distortions of Competition,* [1976] [1976-1978 Transfer Binder, New Developments] COMM. MKT. REP. (CCH) ¶ 9853.

64. [1976-1978 Transfer Binder, New Developments] COMM. MKT. REP. (CCH) ¶ 9800, at 9793.

65. For a discussion of the Commission decision, see Swan, *The EEC United Brands Decision: Can Chiquita Banana Find Happiness in Europe?* 7 CAL. W. INT'L L. J. 385 (1977).

first delineated the essential elements for proving a violation of Article 86 of the Treaty of Rome: "The prohibited situation therefore requires a combination of three elements: the existence of a dominant position; an improper exploitation of that position; and the possibility that trade between Member States may be affected thereby."[66] However, it has not been until recent years that the Court has begun to develop a body of jurisprudence respecting article 86.

A. *Presence of a Dominant Position*

Article 86 and related regulations of the Council of Ministers are silent as to what constitutes the presence of a dominant position. Clearly, a dominant position may be something less than outright monopoly; yet, it also appears that it must be more than mere dominance in terms of market share.[67]

From the *Continental Can* decision to the *United Brands* decision, the Commission has remained persistent in its characterization of a dominant position.[68] The Commission's primary emphasis is on "overall independence of behavior," which is based on a broad economic analysis of the given fact situation.

The Court of Justice, in its various judgments centering around article 86, has considered a number of criteria to be significant in determining the existence of a dominant position. Perhaps the most enduring theme of the Court was first articulated in the 1971 *Deutsche-Grammophon* case, wherein the Court held that an enterprise is in a dominant position when it is able "to prevent effective competition on an important

66. Parke, Davis & Co. v. Probel, [1968] [1967-1970 Transfer Binder] COMM. MKT. REP. (CCH) ¶ 8054, at 7825.

67. *See generally* R. JOLIET, MONOPOLIZATION AND ABUSE OF A DOMINANT POSITION 241 (1970); and D. MCLACHLAN & D. SWANN, *supra* note 20, at 218-27.

68. [1978] 3 COMM. MKT. REP. (CCH) ¶ 8429, at 7736.

> Undertakings are in a dominant position when they have the power *to behave independently* without taking into account, to any substantial extent, their competitors, purchasers and suppliers. Such is the case where an undertaking's market share, either in itself or when combined with its know-how, access to raw materials, or capital enables it to determine the prices or to control the production or distribution of a significant part of the relevant goods. It is not necessary for the undertaking to have total dominance such as would deprive all other market participants of their commercial freedom, so long as it is strong enough in general terms to devise its own strategy as it wishes, even if there are differences in the extent to which it dominates individual submarkets. (Emphasis added.)

part of the relevant market."[69] In *Continental Can*, the Court of Justice found dominance in a "relevant product market" to be critical, which was the first instance in which the Court had examined this criterion in any depth.[70] In other cases (*e.g.*, *Suiker Unie*)[71] the Court placed primary focus upon the market share of an enterprise within a relevant product market.

The most helpful and comprehensive enunciation by the Court of Justice with respect to its concept of a dominant position is contained in the *United Brands* judgment:

> The dominant position referred to in this article [86] relates to a position of economic strength enjoyed by an undertaking which enables it to *prevent effective competition* being maintained on the *relevant market* by giving it the *power to behave to appreciable extent independently* of its competitors, customers and ultimately of its consumers. In general, a dominant position derives from a combination of several factors which, taken separately, are not necessarily determinative. (Emphasis added.)[72]

On the basis of the above synthesis made by the Court of Justice, in assessing whether an enterprise is in a dominant position within the Common Market, it is necessary to determine: (1) the relevant product market, (2) the relevant geographic market,[73] and (3) the position of economic power such enterprise enjoys within the market. This latter requirement combines the Commission's notion of "independent behavior" with the Court's early theme of "power to prevent effective competition." As evidenced by *United Brands*, the Court is establishing a sophisticated economic analysis on a case-by-case basis in order to determine the existence of a dominant position.

1. *Relevant Product Market*

In the *Continental Can* judgment, the Court of Justice decided against the Commission primarily for failure to clearly define the "relevant product market." In this case the Commis-

69. Deutsche-Grammophon Gesellschaft mbH v. Metro-SB-Grossmärkte GmbH & Co. K.G., [1971] [1971-1973 Transfer Binder] COMM. MKT. REP. (CCH) ¶ 8106, at 7193.

70. [1971-1973 Transfer Binder] COMM. MKT. REP. (CCH) ¶ 8171, at 8301-2.

71. "Suiker Unie" (Cooperative Verenigning) UA v. Commission of the European Communities [1975] [1975 Transfer Binder] COMM. MKT. REP. (CCH) ¶ 8334.

72. [1978] 3 COMM. MKT. REP. (CCH) ¶ 8429, at 7708.

73. Art. 86, note 12 *supra*. The criterion for establishing the relevant geographic market is that the dominant position must be in the Common Market or "in a substantial part of it."

sion declared a merger between a newly-formed, wholly-owned Delaware subsidiary of Continental Can (Europemballage) and a Dutch corporation (Thomassen) which produced metal and other containers, to be an abuse of a dominant position. Europemballage was specifically created for the purpose of effecting the merger. Continental Can also transferred its interest in an 85%-controlled German subsidiary (Schmalbach) to Europemballage. Schmalbach held between 80-90% of the German supply market for tins used for fish and shellfish, 70-80% in the German market for meat cans, and between 50-55% in the market for metal lids. The Commission determined that there were three relevant product markets: (1) a "market for light metal containers for canned meat products;" (2) a "market for light metal containers for canned sea food;" and (3) a "market for metal enclosures for the food packing industry, other than crown corks." The Commission concluded that Continental Can, through its subsidiaries, dominated each of these markets.[74]

The Court of Justice stressed that:

> the limits of the relevant market are of major importance, since the possibilities for competition can only be judged on the basis of the properties of the products in question, which are especially suited for satisfying a continuing demand and appear to be changeable with other products only to a small degree.[75]

In this respect, the Court gave deference to the question of "demand substitution," that is, the extent to which demand may be satisfied by interchangeable products, such as glass and plastic containers. However, in criticizing the Commission for failing to "state in detail the peculiarities which distinguish these three markets from one another and, therefore, necessitate their separate treatment,"[76] the Court seemed more concerned with the possibility of "production substitution" than "demand substitution." Production substitution essentially arises when, with simple adjustments in the manner of production and/or supply, a producer of one product can produce and supply products of the type in question or suitable substitutes therefor.[77] The Court held against the Commission primarily

74. [1970-1972 Transfer Binder, New Developments] COMM. MKT. REP. (CCH) ¶ 9481, at 9032.

75. [1971-1973 Transfer Binder] COMM. MKT. REP. (CCH) ¶ 8171, at 8301.

76. *Id.*

77. For a general discussion of the economic implications of "production" and

because the Commission had failed to prove that competitors in other fields in the market for light metal containers could not "by mere adaptation" enter into this market with sufficient strength to form a serious counterweight. In effect, the Commission had not stated sufficiently why the alleged relevant markets were separate and distinct from each other.[78] A better factual showing by the Commission may well have changed the day.

In the 1972 decision in *Commercial Solvents,*[79] the Commission found that a group of companies controlled by Commercial Solvents enjoyed a worldwide monopoly in the production of a raw chemical used to produce an end drug product, and that its denial of the raw chemical through its Italian subsidiary to an Italian enterprise constituted an abuse of its dominant position within the EEC. The Commission held that both the raw chemical and the end drug product constituted separate markets, and that Commercial Solvents held a dominant position in each of such markets. Commercial Solvents contested this finding on appeal and asserted that no separate markets existed, particularly as other raw chemicals could be used, and were in fact being used, to produce the end product. The Court of Justice was unimpressed with the arguments for product substitution, as such adaptations had not been demonstrated on an industrial scale and would result in uneconomic prices. With respect to the question of whether there were two distinct markets, the Court decided that a dominant position could exist in the market for the raw chemical without having to take into consideration the market for the end product.[80] The Advocate General had argued to no avail that the question of the two markets could not logically be treated independently.[81]

"demand" substitution, see P. SAMUELSON, ECONOMICS, chs. 20, 22 (10th ed. 1976).

78. [1971-1973 Transfer Binder] COMM. MKT. REP. (CCH) ¶ 8171, at 8301-2.

79. [1973-1975 Transfer Binder, New Developments] COMM. MKT. REP. (CCH) ¶ 9543.

80. [1974 Transfer Binder] COMM. MKT. REP. (CCH) ¶ 8209, at 8819.

> [I]t is in fact possible to distinguish the market in raw material necessary for the manufacture of a product in the market in which the product is sold. An abuse of the dominant position on the market of raw materials may thus have effects restricting competition in the market on which the derivatives of the raw materials are sold, and the effects must be taken into account in considering the effects of an infringement, even if the market for the derivative does not constitute a self-contained market.

81. *Id.* at 8829.

In its 1975 decision in *General Motors,*[82] the Commission evolved a strained definition of the relevant market. The Commission had alleged that General Motors of Belgium had violaed article 86 by charging excessive prices in a substantial part of the Common Market for the issue of certificates and shields. After inspecting Opel vehicles to check their conformity with the generally approved type, and after determining identification of the vehicles and those registered abroad for no more than six months, General Motors was required to issue the certificates and shields under Belgian law. General Motors was the sole authorized agent for Opel in Belgium. General Motors countered that this inspecting function was ancillary to the automobile market, that such activity did not constitute a separate market, and that by virtue of Belgian law, General Motors' ability to fix prices was sanctioned by the Belgian government. The Court held, however, that this legal monopoly, when combined with the freedom to fix prices, led to a dominant position, the function of inspecting the particular car brand itself being the relevant market for purposes of article 86.[83]

In its 1976 decision in *Hoffman-LaRoche,*[84] the Commission determined that the Swiss pharmaceutical company had abused its dominant position with respect to each group of thirteen vitamins available for sale within the Common Market. It considered each individual group of vitamins to constitute a distinct product market inasmuch as each group was "particularly suited to satisfy stable requirements and [was] not, or at least not to any significant extent, interchangeable with any other group or with any other products."[85] Here the

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> [I] do not think that the question whether the market for the raw materials for the production of a particular compound is a relevant market can, logically, be divorced from the question of whether the market for that compound is a relevant one. The consumer, after all, is interested only in the end product, and it is detriment to the consumer, whether direct or indirect, with which Article 86 is concerned. . . . So it was legitimate, in my opinion, for CSC to seek . . . to establish that the market for ethambutol was but one of a number of interchangeable antipulmancry tuberculosis drugs.

82. *General Motors Fined for Monopoly Practices,* [1974] [1973-1975 Transfer Binder, New Developments] COMM. MKT. REP. (CCH) ¶ 9705.

83. General Motors Continental N.V. v. Commission of the European Communities [1975] [1975 Transfer Binder] COMM. MKT. REP. (CCH) ¶ 8320.

84. [1976-1978 Transfer Binder, New Developments] COMM. MKT. REP. (CCH) ¶ 9853.

85. *Id.* at 9875-11.

Commission focused on the possibility of demand substitution.

In *United Brands*, the Commission asserted that the relevant market was bananas. UBC countered that the relevant market was the fruit market in general. The Commission based its arguments on the relevant market primarily upon research conducted by the Food and Agriculture Organization in parts of France, Germany, and England.[86] This study demonstrated that the prices and availabilities of other fruits had little impact on the prices and availabilities of bananas and that this finding was applicable not only to year-round fruits (*e.g.*, oranges and apples), but also to many seasonal fruits. The Commission concluded that "the effects of the prices and availabilities of other types of fruits [were] too brief, too ineffective and too sporadic, applying to different fruit in different places, for such other fruit to be regarded as forming part of the same market as bananas or as a substitute therefor."[87] The Commission also emphasized that bananas form a significant part of the diets of certain consumer sectors, such as the very young, the sick, and the elderly. In effect, the Commission concluded that the choice of bananas is "a matter of customer preference, and customers do not readily accept other fruits as a substitute."[88] The Court of Justice supported the Commission's position.

In considering whether the banana was in fact interchangeable with other fruit products, the Court of Justice considered such factors as the production of bananas over the course of the year, possible cross-elasticity of demand (*i.e.*, the degree to which the relevant demand for the product responds to changes in the price of each relative to the price of the other), the physical characteristics of the banana distinguishing it from other fruits, and the composition of consumer sectors. Based on this analysis, the Court concluded that there was a small degree of "substitutionability," that there was a relatively consistent consumer demand for bananas, which could be satisfied by UBC throughout the course of the year, and that

86. FAO Commodity Policy Studies, Demand Interrelationships between Major Fruits, No. 19, Rome 1969; Competition between Bananas and Summer Fruits: Preliminary Case Studies, CCP BA 73/8, July 1973.

87. [1976-1978 Transfer Binder, New Developments] COMM. MKT. REP. (CCH) ¶ 9800, at 9785.

88. *Id.*

a large number of consumers could not be "enticed away from the consumption of this product by the arrival of fresh fruit on the market, even when the seasonal peak periods affected it for a limited period of time." Accordingly, the Court held that the banana market was in fact the relevant market, inasmuch as it was "sufficiently homogeneous and distinct from the market for other fresh fruits."[89]

2. *Relevant Geographic Market*

In determining the relevant geographic market, the Court of Justice stated in *Suiker Unie:*

> For the purpose of determining whether a specific territory is large enough to amount to 'a substantial part of the common market' within the meaning of Article 86 of the Treaty the pattern and volume of the production and consumption of the said product as well as the habits and economic opportunities of vendors and purchasers must be considered.[90]

In this case, the Court held that the Belgo-Luxembourg sugar market constituted a "substantial part" of the Community. In so concluding, the Court analyzed the increased production in this market between 1969 and 1972 and its increased percentage share in comparision with the overall Community market. By use of these same criteria, the Court also held Holland and the southern part of Germany each to constitute a "substantial part" of the Community. Thus, the determination rests not only upon the extent of the geographical area, but also upon the product market in that area and the relationship of that product market to that of the entire Community market.[91]

In *United Brands,* the Commission found that Germany, Denmark, Ireland, the Netherlands, and Belgium-Luxembourg comprised the relevant geographic market within which it was necessary to consider whether UBC had the power to hinder effective competition. The Commission was of the view that the "[e]conomic conditions in this part of the Community allow importer/distributors to carry on their trade in bananas normally and there are no noticeable economic obstacles in the way of UBC as compared with other importer/distributors."[92]

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89. [1978] 3 COMM. MKT. REP. (CCH) ¶ 8429, at 7705.

90. [1975 Transfer Binder] COMM. MKT. REP. (CCH) ¶ 8334, at 8214.

91. For a discussion of the case, see Gijlstra and Murphy, *Some Observations on the Sugar Cases,* 14 COMM. MKT. L. REV. 45 (1977).

92. [1976-1978 Transfer Binder, New Developments] COMM. MKT. REP. (CCH) ¶ 9800, at 9785.

The Commission asserted that the whole structure of UBC's European operations, with concentration on its Dutch subsidiary, was geared to the marketing of its bananas in a single center for the whole of that part of the Community. The other Member States of the Community (*i.e.*, France, Italy, and the United Kingdom) were excluded from this geographic market, notwithstanding the significant economic presence of UBC (or its affiliate) in these countries, because of the special circumstances pertaining to import arrangements and trading conditions and the fact that bananas of various types and origins were sold in those countries.[93]

UBC countered that the Commission should have more clearly determined the geographic market because of the differences in conditions of competition in the Member countries within the alleged geographic market (*e.g.*, differences in systems of customs duties and consumer habits). The Court, conceding that such differences existed with respect to applicable tariffs and transportation costs, concluded that the conditions of competition within the countries comprising this relevant market were "sufficiently harmonious" to be considered in their entirety, and therefore, a relevant geographic market for purposes of article 86.[94]

3. *Economic Power*

An analysis of the economic position enjoyed by an enterprise within a relevant market usually commences with a quantitative analysis, particularly with respect to the market share. For example, in *Suiker Unie,* the Court focused on the fact that the leading Belgian producer of sugar accounted in prices for 85% of Belgian production. However, the Court noted that while this figure is "highly significant," it must still be "evaluated in light of the negligible volume of sugar imports in Belgium." As a result of all the circumstances, the producer enjoyed sufficient economic power "to impede effective competition" on the market in question, and consequently, during the relevant period, occupied a dominant position on this market.[95]

In *United Brands,* the Commission concluded that there was sufficient economic power enjoyed by UBC to constitute

93. *Id.* at 9785-86.
94. [1978] 3 COMM. MKT. REP. (CCH) ¶ 8429, at 7706-7.
95. [1975 Transfer Binder] COMM. MKT. REP. (CCH) ¶ 8334, at 8215.

a dominant position. This determination was based on a series of factors which, when taken together, produced "a degree of overall independence in its behavior on the market in question which enable[d] it to hinder effective competition within this part of the Community."[96] These factors included the market share compared with that of its competitors, the diversity of its sources of suppliers, the harmonious nature of its products, the organization of UBC's production and transportation systems, UBC's marketing system and publicity campaigns, the diversified nature of UBC operations, and most significantly, UBC's overall vertical integration. UBC denied this conclusion as unsupported by any evidence. UBC asserted that an objective evaluation of its structure and the relevant market conditions would indicate that it was not in a dominant position in a relevant market.[97]

The Court of Justice analyzed UBC's market position from two perspectives: first, UBC's internal operating structure, and second, the competitive situation within the market. In considering the high degree of vertical integration of UBC at all stages (*i.e.*, producing, packaging, transporting, selling, and displaying), the Court concluded that UBC had firm control over the economic destiny of the product. The Court of Justice next considered the impact on competition within the relevant market. The fact that UBC's share of the relevant market was always more than 40% and nearer 45% was significant, but did not automatically infer that UBC dominated this market. In addition to market share, the Court felt it necessary to consider the strength and number of competitors. UBC's share of the market was seven times greater than its closest competitors, with all other competitors falling far behind. The Court interjected temporal considerations (which may in future cases evolve as a separate criterion), by observing that, while there were certain periods when competition was enhanced, these periods were limited both in time and space. Moreover, the Court stressed that UBC's overall economic strength permitted it the flexibility to direct strategy against new competitors within the market, which provided additional obstacles to the existing practical barriers for the entry of new competition

96. [1976-1978 Transfer Binder, New Developments] COMM. MKT. REP. (CCH) ¶ 9800, at 9787.

97. [1978] 3 COMM. MKT. REP. (CCH) ¶ 8429, at 7708.

(*e.g.*, large capital expenditures).[98]

UBC raised two objections concerning this issue, namely that its other competitors were able to use the same methods of production and distribution if they so chose, and that UBC had suffered financial losses in its banana division for a five-year period from 1971 to 1976. To the first objection, the Court responded that none of UBC's competitors were able to use the same methods as they "came up against almost insuperable practical and financial obstacles." With respect to the latter objection, the Court noted that an undertaking's economic strength "is not measured by its profitability." On the basis of this total economic analysis of UBC's structure and its situation with respect to the relevant market, the Court held that the "cumulative effect of all the advantages enjoyed by UBC thus ensures that it has a dominant position on the relevant market."[99]

B. *Abusive Practices*

In the *United Brands* judgment, the Court of Justice was concerned primarily with four alleged abuses of article 86:

(i) restrictions on the resale of green bananas;

(ii) refusal to continue to supply a longstanding customer;

(iii) discriminatory pricing; and

(iv) unfair pricing.[100]

Under the terms of article 86, the mere presence and enjoyment of a dominant position is not in and of itself prohibited. What is prohibited is the abuse or the improper exploitation of the position.[101] In this sense, article 86 is neutral with respect to the matter of size.[102] However, article 86(2) does set forth certain broad, illustrative types of activities which would constitute an abuse. Such abusive activities include: imposing unfair purchase or selling prices or other unfair trading conditions; limiting production, markets, or technical development; applying dissimilar conditions to equivalent transactions; and

98. *Id.* at 7708-11.

99. *Id.* at 7711.

100. Note 34 *supra*.

101. Treaty of Rome, Art. 86, note 12 *supra*.

102. *See generally* European Commission, *Annual Report on Competition Policy*, issued annually since 1971.

making the conclusion of contracts subject to acceptance of supplementary obligations which have no connection with the subject of the contracts.[103] These criteria indicate that they apply "not only to practices that are likely to cause an immediate detriment for consumers, but also to practices which, because of their effect on the structure of actual competition . . . are harmful to them [consumers]."[104] Moreover, while these categories of activities do not purport to be exhaustive, they are sufficiently broad that most activities (including the alleged abuses in *United Brands*) which could be determined to be abusive would fall within one of these four categories.[105] "[T]he restrictions of competition, which the Treaty permits under certain circumstances because the various Treaty objectives must be reconciled, find a limit in the requirements of Articles 2 and 3, beyond which there is a danger that a weakening of competition would be contrary to the goals of the Common Market."[106] Therefore, irrespective of any specific classification of an activity, every alleged "abusive exploitation" under article 86 must be tested objectively, regardless of any consideration of fault.

1. *Prohibitions on Resale*

In *United Brands* the Commission specifically objected to UBC's above-mentioned conditions of sale to its distributor/ripeners.[107] These general conditions had been in effect since 1967, although not always in writing. In January 1976, UBC circulated a letter to all its established customers to the effect that these general conditions were not intended to forbid the sale by a duly appointed ripener to another Chiquita ripener of green Chiquita bananas or the resale of unbranded green bananas.[108] The Court of Justice, however, rejected UBC's position and upheld the Commission's order to cease the prohibition on resale.[109] The Court viewed this general condition of sale

103. The text of article 86(2) is quoted at note 12 *supra*.

104. [1971-1973 Transfer Binder] COMM. MKT. REP. (CCH) ¶ 8171, at 8300.

105. *See* Samkalden and Druker, *Legal Problems Relating to Article 86 of the Treaty of Rome*, 3 COMM. MKT. L. REV. 158, at 176 (1965).

106. [1971-1973 Transfer Binder] COMM. MKT. REP. (CCH) ¶ 8171, at 8299.

107. [1978] 3 COMM. MKT. REP. (CCH) ¶ 8429, at 7668.

108. *Id.* at 7769.

109. *Id.* at 7713.

> Although it is commendable and lawful to pursue a policy of quality . . . such a practice can be justified only if it does not raise obstacles whose effect goes beyond the objective to be obtained. In this case, . . . the

in a similar manner as it would a prohibition of exports.[110]

2. *Refusal to Continue Supplies*

The Commission also concluded that UBC's refusal to continue supplies to Olesen could not be justified objectively and was an arbitrary interference in the management of Olesen's business, which had caused it to suffer damage and which was designed to dissuade UBC's ripeners from selling bananas bearing competing brand names or at least from advertising them. The Commission viewed these facts as tantamount to a violation of article 86.[111] UBC endeavored to justify their refusal to sell because of Olesen's dealings with UBC's primary competitor. Moreover, UBC contended that the refusal did not constitute an abuse inasmuch as it did not affect the actual competition on the Danish market and did not affect trade between Member States.[112] The Court of Justice was not impressed with UBC's argument:

> [A]n undertaking in a dominant position for the purpose of marketing a product—which cashes in on the reputation of a brand name known and valued by the consumers—cannot stop supplying a long-standing customer who abides by regular commercial practice, if the orders placed by the customer are in no way out of the ordinary. Such conduct is inconsistent with the objectives laid down in . . . the Treaty [of Rome] . . . since the refusal to sell would limit markets to the prejudice of consumers and would amount to discrimination which might in the end eliminate a trading party from the relevant market. . . . Such a course of conduct amounts therefore to a serious interference with the independence of small or medium sized firms in their commercial relations with the undertaking in a dominant position

prohibition on resale imposed upon duly appointed 'Chiquita' ripeners and the prohibition on the resale of unbranded bananas . . . are without any doubt an abuse of the dominant position since they limit markets to the prejudice of consumers and affect trade between Member States, in particular by partitioning national makets. Thus, UBC's organization of the market confined the ripeners to the role of suppliers of the local market and prevented them from developing their capacity to trade vis-à-vis UBC.

110. *Id.* at 7711. "Apart from the fact that this obligation indirectly helps to strengthen and consolidate UBC's dominant position, it makes any trade in UBC's green bananas, whether branded or not, either within a single State or between Member States, almost impossible."

111. [1976-1978 Transfer Binder, New Developments] COMM. MKT. REP. (CCH) ¶ 9800, at 9790.

112. [1978] 3 COMM. MKT. REP. (CCH) ¶ 8429, at 7714.

> and this independence implies the right to give preference to competitor's goods.[113]

The applicant also argued that in view of a 40% fall in the price of bananas on the Dutch market in the latter two weeks of 1974 that competition had not been affected by the refusal to supply Olesen. The Court of Justice dismissed this contention, finding that this fall in prices was attributable to the lively competition in which UBC and Castle & Cook were engaged. The Court also found that it was immaterial whether this behavior on the part of UBC related to trade between Member States "once it [had] been shown that such elimination [would] have repercussions on the terms of competition in the Common Market."[114]

The Court of Justice in *Commercial Solvents* had previously made clear that if an enterprise in a dominant position with respect to the supply of goods to its customers in fact competes with its customers, it cannot act in such a manner as to eliminate or impair competition, whether by a refusal to supply or by other discriminatory means.[115] If there is a refusal to supply regular customers, the dominant enterprise must justify objectively such refusal. In all events, the refusal to supply a longstanding customer who purchases with a view to reselling to another Member State is deemed by the Court of Justice to have "an appreciable effect" on trade between Member States, and therefore, the refusal is violative of article 86.

3. *Discriminatory and Unfair Pricing*

The most significant aspect of *United Brands* with respect to the determination of abuse of a dominant position centers around UBC's pricing practices, particularly whether these practices were discriminatory and/or unfair.

In determining whether UBC's pricing practices were discriminatory, the Commission concluded: "For an undertaking in a dominant position, a policy of systematically setting prices at the highest possible level, resulting in wide price differences, cannot be objectively justified, particularly where that undertaking maintains market segregation."[116] In reaching this con-

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113. *Id.*

114. *Id.* at 7715.

115. [1974 Transfer Binder] COMM. MKT. REP. (CCH) ¶ 8209, at 8819.

116. [1976-1978 Transfer Binder, New Developments] COMM. MKT. REP. (CCH) ¶ 9800, at 9788.

clusion, the Commission utilized the same test previously suggested by the Court of Justice in *Deutsche-Grammophon*, which was an analysis of price differences for the same products in different Member States.[117]

UBC countered that its prices were determined by market forces and therefore were not discriminatory. Moreover, UBC asserted that the average difference in the price of Chiquita bananas between the various markets in question was only 5% in 1975. Prices were calculated in any given week in order to reflect as much as possible the anticipated yellow market price of the following week for each national market. UBC insisted that so long as the Community had not set up institutions and machinery for a single banana market, the various markets would remain national and would respond to a variety of distinctive factors.[118]

The Court of Justice agreed with the Commission that the policy of differing prices enabled UBC to apply dissimilar conditions to equivalent transactions with other trading parties, thus placing them at a competitive disadvantage. The Court recognized that because of the lack of a Community market, price differentials may legitimately arise; however, the Court appears to suggest that the dominant firm must be able to justify price differentials between national markets. Accordingly, while conceding that the responsibility for establishing a single banana market did not rest with UBC, the Court stressed that UBC's pricing practices must comply with the rules and regulations and coordination of the market laid down by the Treaty of Rome. Therefore, once the differences in such matters as transportation costs, taxation, customs duties, wages, differences in parity of currency, and the density of competition have been assessed and taken into account, the Treaty of Rome would require UBC to exercise responsibility toward consumers with respect to the final pricing.[119]

The Court of Justice derived from the facts that UBC did impose its selling price on the intermediate purchaser and that these discriminatory prices, which varied according to the circumstances of the Member States, constituted "many obsta-

117. [1971-1973 Transfer Binder] COMM. MKT. REP. (CCH) ¶ 8106, at 7193.
118. [1978] 3 COMM. MKT. REP. (CCH) ¶ 8429, at 7716-17.
119. *Id.* at 7717.

cles to the free movement of goods and were intensified by the clause forbidding the resale of bananas while still green and reducing the deliveries of the quantities ordered."[120] The Court concluded that UBC's pricing policy amounted to a "rigid partitioning of national markets . . . at price levels which were artifically different, placing certain distributor/ripeners at a competitive disadvantage." Such practice was an abuse of a dominant position for purposes of article 86.[121]

The point on which the Commission and Court differed concerned whether the prices charged by UBC to its customers in Germany, Denmark, the Netherlands, and the Belgo-Luxembourg area were unfair. In *General Motors*, the Court had proposed a test of price unfairness based on the relationship of the price to the economic values of the services provided, particularly when the effect was to curb parallel imports by neutralizing the possibility of more favorable price levels as applied in other sales areas of the Community.[122] The Commission felt that UBC's pricing practices met this test; however, the Court of Justice, in applying the *General Motors* test, rejected the Commission's view, and annulled that part of the Commission's decision which found that UBC had imposed unfair prices for the sale of its bananas.

The Court of Justice did not disagree with the legal arguments of the Commission. However, the Court found that the Commission had failed to produce "adequate legal proof of the facts and evaluation which form the foundation of its findings that UBC had infringed Article 86 of the Treaty by directly and indirectly imposing unfair selling prices for bananas."[123] The Court specifically criticized the Commission for its failure to analyze UBC's cost structure, which made it impossible for a proper analysis of differentials in profit margins. The Court felt that the Commission was at least under a duty to require UBC to produce particulars of all the constituent elements of its production cost and not simply to base its view of excessive prices on an analysis of the differences between prices charged in the different Member States. The Court was particularly unimpressed by the comparisons between prices charged in the

120. *Id.*
121. *Id.*
122. [1975 Transfer Binder] COMM. MKT. REP. (CCH) ¶ 8320, at 7735.
123. [1978] COMM. MKT. REP. (CCH) ¶ 8429, at 7719.

Irish market (which were the lowest) and those charged in other parts of the Community. Consequently, the Court held that the burden of proof of showing unfair prices rested with the Commission and that the Commission had failed to meet this burden.[124]

C. *Effect on Trade Between Member States*

The requirement of article 86 that the abuse of the dominant position be apt to "affect trade between Member States" is analogous to that requirement contained in article 85(1). Under article 85(1) the Court of Justice has deemed trade between Member States to be affected whenever the restrictive practice may impair, directly or indirectly, potentially or actually, the realization of the unified Common Market.[125] Paradoxically, a practice may in fact increase trade between Member States, yet also be deemed a restrictive agreement for purposes of article 85(1) because the actual or potential effect upon trade between the Member States does not necessarily have to be prima facie adverse.[126] These applications of principles under article 85(1) would appear to be equally apropos for purposes of article 86.[127]

Both the Commission and the Court of Justice have generally had little difficulty in interpreting the facts of a given case as meeting this requirement of article 86. The only major qualification had been the application of a *de minimis* rule which requires that trade between Member States be "appreciably" affected by the agreement or act in question.[128] In *United Brands*, the Commission determined that UBC's

124. *Id.*

125. *See, e.g.*, S. A. Cadillon v. Firma Höss Maschinenbau K.G., [1971] [1971-1973 Transfer Binder] COMM. MKT. REP. (CCH) ¶ 8135, at 7542.

126. *See, e.g.*, Consten and Grundig v. Commission of the European Communities, [1966] [1961-1966 Transfer Binder] COMM MKT. REP. (CCH) ¶ 8046.

127. *Cf.* [1974 Transfer Binder] COMM. MKT. REP. (CCH) ¶ 8209, at 8821.

> When an undertaking in a dominant position within the Common Market abusively exploits its position in such a way that a competitor in the Common Market is likely to be eliminated, it does not matter whether the conduct relates to the latter's exports or its trade within the Common Market, once it has been established that this elimination will have repercussions on the competitive structure within the Common Market.

Here, the Court of Justice appears to be equating possible repercussions with the possibility of effect on trade between Member States.

128. *See, e.g.*, European Commission, *Guidelines to Promote Cooperation between Firms*, [1970] [1970-1972 Transfer Binder, New Developments] COMM. MKT. REP. (CCH) ¶ 9367.

dominant position was capable of affecting trade between Member States to an appreciable extent as follows:

(i) the prohibition on the resale of green bananas impeded trade between distributor/ripeners in different Member States and deflected the flow of trade from its normal course;

(ii) the refusal to supply a longstanding customer who purchased with a view toward reselling in another Community state limited markets and could have eliminated a trading party from the relevant market;

(iii) the application of dissimilar prices for equivalent transactions was liable to encourage or discourage the export of those bananas from one Member State to another according to the different price levels in the various Member States; and

(iv) the imposition of unfair prices on customers in certain Member States was liable to affect the quantities of Chiquita bananas traded between Member States, in that it encouraged export from Member States where such unfair prices were not opposed and vice versa.[129]

The rationale used by the Commission with respect to points three and four above is difficult to accept, because such conduct would in fact produce a beneficial effect on trade between the Member States. Such considerations, however, do not appear to be relevant, as the Court of Justice sustained the Commission's findings on point three above and would most likely have sustained the finding with respect to the effect on trade between Member States as to number four if the Commission had met its burden of proof in showing unfair prices.[130] The Court of Justice also concurred with the Commission on point one above because this prohibition was capable of affecting trade between Member States and dividing up national markets[131] and on point two because this had an influence on the normal movement of trade and an appreciable effect on trade between Member States.[132] When there is evidence of actual harmful effect on the market, as was the case in *United Brands*, any consideration of possible beneficial effect is appar-

129. [1976-1978 Transfer Binder, New Developments] COMM. MKT. REP. (CCH) ¶ 9800, at 9790.

130. [1978] 3 COMM. MKT. REP. (CCH) ¶ 8429, at 7717.

131. *Id.* at 7713.

132. *Id.* at 7715.

ently precluded. The emphasis of both the Commission and the Court of Justice is, therefore, directed toward the potentiality of a harmful effect brought about by abusive exploitation of a dominant position on the market. The factual situation of *United Brands* provided the Commission and Court with an opportunity to find both a dominant position and an abuse of that position.

IV. CONCLUSION

Article 86 will undoubtedly continue to be a fertile device for the European Commission in attacking the activities of dominant corportions doing business within the Community, whether such corporations are based within the EEC or outside. The European Court of Justice appears to appreciate the legal and economic potential of article 86 and has shown itself substantially in agreement with the Commission with respect to the legal analysis of this article. However, the Court of Justice appears to be signalling the Commission to take a more careful and detailed approach in developing and proving its allegations.

This writer does not view the differences between the Court of Justice and the Commission as a significant clash in basic legal or economic antitrust philosophies, nor does he believe that such differences will have a long term effect upon the energetic institution of cases under article 86 by the Commission. The agressiveness of the Commission will, however, most likely be tempered by the requirement of the strict, analytical proof of facts required by the Court of Justice.

With respect to the question of the extraterritorial application of the EEC antitrust laws, it appears that for the moment both the Commission and the Court of Justice will continue to favor the "single enterprise" theory over any embrace of the "effects" doctrine of extraterritorial jurisdiction. Although one can argue the legal consistency of the "single enterprise" doctrine, and particularly its refinement into the "unity of action" doctrine, there is little doubt that the Commission will continue to act with confidence against foreign multinationals acting through EEC subsidiaries in situations in which the Commission feels there is a violation of either Articles 85 or 86 of the Treaty of Rome. Moreover, it appears clear that the Court of Justice will uphold such an extension of jurisdiction both on the basis of its interpretation of articles 85 and 86 and of its overall view of the legal personality of the Community. Given a fact situation that does not accommodate the "single enterprise" theory, it is most likely that the Commission will once again resurrect its "effects" doctrine of extraterritorial jurisdiction, and if necessary, press for a clear resolution of the matter before the Court of Justice.

Management Services Agreements with a Foreign Parent Corporation and the Income Source Determination Rules

JOHN L. RUPPERT*

INTRODUCTION

With the proliferation of multinational brother-sister,[1] parent-subsidiary,[2] and other "related groups"[3] of corporations, numerous provisions of the Internal Revenue Code have increasingly become traps for the unwary corporate taxpayer.[4] One area in particular that may be the subject of future scrutiny by the Internal Revenue Service is the interrelationship between the income source determination rules of sections 861 through 864[5] and the withholding at the source requirements of

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1. I.R.C. § 1563(a)(2)(A), (B). Brother-sister corporations are two or more corporations in which five or fewer persons own stock possessing (a) 80 percent of the voting power or at least 80 percent of the total value of shares of all classes of a corporation, and (b) more than 50 percent of the combined voting power of all classes of stock entitled to vote, or more than 50 percent of the total value of shares of all classes of stock, taking ownership into account only to the extent it is identical with respect to each corporation. For specific examples of the brother-sister relationship *see* Treas. Reg. § 1.1563-1(a)(3)(ii), examples (1)-(2) (1976).

2. I.R.C. § 1563(a)(1)(A), (B). A parent-subsidiary relationship is one or more chains of corporations connected through stock ownership with a common parent if (a) the 80 percent ownership of voting stock or 80 percent total value requirements are met, and (b) the common parent meets the same two tests for at least one of the other corporations. For specific examples of the parent-subsidiary relationship *see* Treas. Reg. § 1.1563-1(a)(2)(ii), examples (1)-(4) (1976).

3. I.R.C. § 1563(a)(3). A combined group of corporations is three or more corporations each of which is a member of a group of corporations described *supra* notes 1-2 and one of which is a common parent corporation in a group of corporations described *supra* note 2 and also is included in a group of corporations described *supra* note 1. For examples of such a relationship *see* Treas. Reg. § 1.1563-1(a)(4)(ii), examples (1)-(2) (1976).

4. In the last 20 years, the area of foreign tax has mushroomed. For a discussion of recent trends in this field *see generally* Brantner, *Taxation and the Multinational Firm*, 65 MANAGEMENT ACCOUNTING 11 (1973); Hammer, *U.S. Taxation of Foreign Corporations and Nonresident Aliens*, 29 So. CAL. TAX INST. 89 (1975); Kragen, *Avoidance of International Double Taxation Arising From Section 482 Reallocations*, 60 CAL. L. REV. 1493 (1972); Lundy, *A Review of U.S. System of Taxation on Foreign Income of Corporations and Subsidiaries*, 160 N.Y.L.J. 34 (1973); Sherfy, *Recent Changes and New Considerations in the International Tax Area*, 53 TAXES 857 (1975); Tillinghast, *United States Income Taxation of Foreign Source Income: A Survey of the Provisions and Problems*, 29 N.Y.U. INST. FED. TAX. 1 (1971).

5. I.R.C. §§ 861-864. These income source determination provisions of the Code

sections 1441 and 1442.[6] "Management fees" agreements present, perhaps, the best example of the potentially difficult problems that these provisions may create for related business entities.

As a starting point, the basic premise of the Code is that a foreign parent corporation, not engaged in a United States trade or business, is nonetheless subject to a flat thirty percent tax on only its United States source fixed or determinable income.[7] Consequently, such factors as the source of an item of income, the nature of the income item, and the very structure of the "management services" agreement that gave rise to the income item are of concern to both the parent corporation and its subsidiary for purposes of avoiding or mitigating unanticipated and often disastrous double taxation.

The potential for such double taxation is simply demonstrated by the following example. The receipt of management services fees by the foreign parent will constitute gross income to the parent and as such will be subject to income tax liability in the foreign state.[8] Simultaneously, the domestic subsidiary

constitute an exclusive three-tier classification system for allocating items of income to particular sources. These provisions play the primary role in determining what income of a foreign corporation will be subject to United States income tax liability. For a general discussion of the impact of these provisions in the foreign tax area *see generally* Hammer, *supra* note 4; Lundy, *supra* note 4; White, *International Tax Planning with U.S. Source Rules*, 51 TAXES 211 (1973).

6. I.R.C. §§ 1441, 1442. These withholding at the source provisions are the principal method of enforcing the United States tax liability of foreign taxpayers not engaged in a trade or business within the United States. For further discussion of these provisions *see* Sitrick, *New Rules on Withholding Payment of Tax on U.S. Income of Foreign Taxpayers*, 28 J. TAX. 110 (1968).

7. I.R.C. § 881 imposes a tax on income of foreign corporations not connected with a United States business at a flat rate of 30 percent. Treas. Reg. § 1.881-2(a)(3) (1976) expressly states that deductions shall not be allowed in determining the amount subject to tax under section 881. In contrast, a foreign corporation engaged in a United States trade or business, but not having a United States office, is taxed only on its United States source income but at two different rates: 30 percent on its gross income from sources not effectively connected with its United States trade or business (I.R.C. § 881(a)), and at the regular corporate rates on that income effectively connected to its United States trade or business (I.R.C. §§ 882, 864(c)(3)). Finally, foreign corporations engaged in a United States trade or business having a United States office are taxed the same as foreign corporations engaged in a United States trade or business without a United States office except that certain foreign source effectively connected income, as defined in I.R.C. §§ 864(c) and 882, is taxed at domestic corporate rates (I.R.C. § 882).

8. Were the foreign parent corporation a domestic corporation, it is unquestioned that management fee income would constitute gross income to the entity. I.R.C. § 61

(payer) corporation would be entitled to an "ordinary and necessary" business deduction for such management fees on its United States income tax return.[9] If management fees constitute the foreign parent's only income from sources outside its state of incorporation, a successful allocation of such services to sources wholly outside the United States will preclude the parent from incurring any United States tax liability. Assuming that no other income from United States operations was earned by the foreign parent during the taxable year,[10] the foreign parent may decide that no United States tax return need be filed.[11] As a result of the foreign parent's decision not to file a return, the three-year statute of limitations of section 6501(a)[12] would be inapplicable, and pursuant to section

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provides: "Except as otherwise provided in this subtitle, gross income means *all income* from whatever source derived, including (but not limited to) the following items: (1) compensation for services, *including fees*." (Emphasis added.) For further discussion *see* Treas. Reg. § 1.61-2(a) (1976). As an example of how a foreign state would treat income from sources outside its boundaries earned by a resident corporation *see* Canadian Income Tax Act, Can. Stat., An Act to Amend the Income Tax Act, c. 63, § 126(2), 126(6), 126(7) (1971).

9. Management fee expenses have been held to be deductible as ordinary and necessary business expenses under I.R.C. § 162. *See* American Savings Bank, 56 T.C. 828, 842-43 (1971); United States Freight Co. & Subsid. v. United States, 70-1 U.S. Tax Cas. ¶ 9244 (Ct. Cl. 1970); Preston Wilson, 20 T.C.M. (CCH) 676 (1961).

10. Unless the corporation falls into the class of foreign businesses not engaged in a United States trade or business, the foreign entity will be subject to the same tax rates as would a domestic corporation on its effectively connected income. *See* I.R.C. §§ 864(c), 882. *See also* note 7 *supra*. For a more detailed discussion of this concept *see* R. RHOADES, INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS §§ 2.21-.40 (rev. ed. 1977).

11. I.R.C. § 6012(a)(2) requires that "every corporation subject to taxation under subtitle A" must file an income tax return for the taxable year. Treas. Reg. § 1.6012-2(g) (1976) elaborates on this mandate by stating that every foreign corporation which is engaged in a trade or business in the United States or which has become subject to taxation under subtitle A must file a return. Subsection (2) of the regulation creates an exception to the obligation to file a return when the foreign corporation, not engaged in a United States trade or business, has its tax liability satisfied by withholding of tax at the source by one so obligated under I.R.C. §§ 1441 and 1442. Even nonresident foreign corporations are required to file returns for all of their I.R.C. § 881(a) income. If the foreign taxpayer should determine that because it received no I.R.C. § 881(a) income for the taxable year, it need not file a return, the entity may have a return calculated and filed for it by the Revenue Service. *See* I.R.C. § 6020. As an example of the Service's power to file a return for a foreign corporation that failed to file a return *see* Cantrell & Cochrane, Ltd. v. Shea, 39-1 U.S. Tax Cas. ¶ 9388 (S.D.N.Y. 1939).

12. I.R.C. § 6501(a) prescribes a general three-year statute of limitations starting on the date the return was filed, or actually due, whichever is later, in the absence of fraud or failure to file a return. *See generally* 10 MERTENS, LAW OF FEDERAL INCOME TAXATION § 57.01 *et seq.* (rev. ed. 1971).

6501(c)(3) tax may be assessed or a proceeding in court for the collection of such tax may be begun without assessment *at any time.*[13] Should the Service subsequently be successful in classifying the management fees as United States source income, pursuant to sections 1461 and 7501, the payer-subsidiary would be personally liable for a tax deficiency in the amount of thirty percent of the total management fees paid.[14] In effect, the related corporations will be taxed twice on the same management fees income, *i.e.*, once in the parent's home and once in the subsidiary's. Other potential concerns such as section 482 reallocations,[15] denials of excessive deductions,[16] or constructive

13. I.R.C. § 6501(c)(3). Two interesting questions arise at this point: (1) Where does the burden of proof lie, and (2) how does the Service compel production of documents? If the corporate taxpayer fails to file a return, must the Service shoulder the burden of proving that a return should have been filed, or must the taxpayer refute the correctness of the Service's assessment? For a general discussion *see* United States v. Lease, 65-2 U.S. Tax Cas. ¶ 9478, at 96,127 (2d Cir. 1965), where the Second Circuit held that the Service had the burden of coming forward and persuading the trier of fact that the taxpayer had a tax liability. As for the production of documents question *see* I.R.C. § 7602. *See also* Matter of Daniels, 56-1 U.S. Tax Cas. ¶ 9451 (S.D.N.Y. 1956). *See* Bartlett, *Authority of the United States Internal Revenue Service to Obtain Information Solely to Aid Foreign Tax Authorities: United States-Canada Tax Treaty,* 28 BULL. INT'L FISCAL DOCUMENTATION 497 (1974).

14. I.R.C. § 1442 imposes a withholding at the source tax of 30 percent on United States source income earned by a foreign corporation. I.R.C. § 7501 provides that any person required to withhold internal revenue tax from any person shall hold such monies in a special trust fund. The amount of such fund shall be assessed, collected, and paid in the same manner, and subject to the same requirements, as are applicable with respect to the taxes from which such fund arises. *Id.* I.R.C. § 1461 states that every person required to withhold taxes is liable for such tax. Treas. Reg. § 1.1461-3(b) (1976) states that for failure to pay the withheld tax to the Service, the withholding agent may be subject to penalties under I.R.C. §§ 6653, 7502. In addition, the withholding agent may be subject to penalties under I.R.C. §§ 6651, 6656, and 7203 for failure to file a return, for willful failure to file a return, and for failing to make a timely deposit of taxes withheld, respectively.

15. I.R.C. § 482. For a good discussion of the impact of section 482 in the multinational corporate context *see* Barnett, *Recent Developments in Allocation of Income,* 46 FLA. B.J. 607 (1972); Brown, *Canada-United States Tax Relations Problems,* 28 TAX. EXEC. 1 (1975); Delise, *Section 482 Allocations of Income to Stockholders for Services Rendered to Closely Held Corporations,* 1972 UTAH L. REV. 491; Kauder, *International Allocations of Income: Problems of Administration and Compliance,* 9 J. INT'L LAW & ECON. 1 (1974); Kragen, *supra* note 4; McGowan, *Taxation of the Multinational,* 22 R.I.B.J. 4 (1973); Wolpe, *When and How Section 482 Is Applied,* 6 PRAC. ACCT. 37 (1973); Note, *Section 482—Internal Revenue Code—Burden of Proof: Arm's Length Dealing,* 25 BAYLOR L. REV. 392 (1973); Note, *New Developments In Allocation of Income Among Commonly Controlled Entities Under Section 482,* 57 MINN. L. REV. 559 (1973); Note, *Allocation—Section 482,* 4 RUT.-CAM. L.J. 445 (1973).

16. I.R.C. § 162(a)(1) provides that there shall be allowed as a deduction all the ordinary and necessary expenses incurred in carrying on a trade or business, including

dividend treatment,[17] which may present additional and related taxation difficulties, are beyond the scope of this paper.

This article will attempt to examine the interaction of the source determination rules of sections 861 through 863 and the withholding at the source requirements of sections 1441 and 1442 in the specific setting of a management services agreement between a foreign parent corporation[18] and its domestic,[19] American subsidiary. Because the United States-Canadian Income Tax Treaty[20] is generally representative of United States income tax treaties as a class, its analogous income source determination provisions will be examined also in some detail. The primary purpose of this article will be to analyze the aforementioned statutory provisions in light of the relevant case law, revenue rulings, and treaty provisions. In addition, those procedures which may assist the taxpayer in supporting

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a reasonable allowance for salaries or other compensation for personal services actually rendered. *See also* Treas. Reg. § 1.162-7 (1976). For an in-depth analysis of the reasonable compensation issue *see* [1977] STAND. FED. TAX REP. (CCH) ¶ 1370-1370.06. *Cf.* Fogg, *How to Apply the Current Rules to Increase Deductions for Professional Fees,* 18 TAX ACCT. 352 (1977) (discussion of analagous payments: startup expenses, computer software expenses, and appraisal fees).

17. Especially in the area of related or controlled corporations' dividend payments in the guise of compensation for services rendered may be recast by the Service as constructive dividends pursuant to I.R.C. §§ 301, 316. *See generally* J. Lupowitz Sons, Inc. v. Comm'r, 497 F.2d 862 (3d Cir. 1974) (bona fide advances between corporations were not constructive dividends); Sammons v. Comm'r, 472 F.2d 449 (5th Cir. 1972) (the test for determining whether intercorporate transfers constitute constructive dividends is whether the majority stockholder primarily benefited); Rushing v. Comm'r., 52 T.C. 888, *aff'd on other grounds,* 441 F.2d 593 (5th Cir. 1971) (adoption of the primary benefit test); *but see* McLemore v. Comm'r, 494 F.2d 1350 (6th Cir. 1974) (two intercorporate transfers were constructive dividends to the sole shareholder, for one allowed him to pay off a personal obligation and the second was not a binding obligation). *See also* Frank, *Brother-Sister Transfer of Funds,* 53 TAXES 693 (1975); Young, *Provoking, Invoking, and Revoking 'Phantom' Dividends,* 21 TUL. TAX INST. 68 (1972).

18. I.R.C. § 7701(a)(5). Foreign, when applied to a corporation, means an entity which is not domestic.

19. I.R.C. § 7701(a)(4) defines "domestic," when applied to a corporation, as referring to an entity created or organized in the United States or under the laws of the United States or of any State.

20. Convention for the Avoidance of Double Taxation and Prevention of Fiscal Evasion in the Case of Income Taxes Between the United States and Canada, March 4, 1942, 56 Stat. 1399, 6 Bevans 244, T.S. No. 983, *as amended by* Supplementary Convention, June 12, 1950, 2 U.S.T. 2235, T.I.A.S. No. 2347, *as amended by* Supplementary Convention, Aug. 8, 1956, 8 U.S.T. 1619, T.I.A.S. No. 3916, *as amended by* Additional Supplementary Convention, Oct. 25, 1966, 18 U.S.T. 3186, T.I.A.S. No. 6415 [hereinafter cited as Convention Between the United States and Canada Respecting Double Taxation].

its allocation of management services to sources wholly or predominantly outside of the United States will be identified and discussed.

I. STATUTORY LAW

A. *Withholding at the Source*

Section 1442 requires that in the case of foreign corporations subject to tax under subtitle A, a tax of thirty percent shall be withheld at the source on those items of income enumerated in section 1441(b).[21] Section 1441(a) and (b) require that all persons having control over, or payment of salaries, wages, premiums, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income, to the extent such items constitute gross income from sources within the United States, shall deduct and withhold at the source a tax equal to thirty percent thereof.[22]

Nowhere in the statute or regulations does the phrase "management fees" appear. Possibly anticipating an argument to the contrary, the Service promulgated regulation 1.1441-2(a) which specifically states that forms of income other than those enumerated were meant to be included within section 1441(a).[23] Additionally, the regulation indicates that "fixed or determinable annual or periodical gain" was meant merely to be descriptive of the "character of a class of income."[24] In conjunction with the Service's extremely broad interpretation of the statute, the courts have also given a broad sweep to the language of section 1441. Alimony payments,[25] proceeds from

21. I.R.C. § 1442, entitled Withholding of Tax on Foreign Corporations.

22. I.R.C. § 1441(a), (b).

23. Treas. Reg. § 1.1441-2(a)(1) (1976) specifically provides: "Section 1441(b) specifically includes in such income [see the list in the text accompanying note 22 *supra*] . . . but other kinds of income are included, as, for instance, royalties."

24. *Id.* The regulation also provides that the term fixed or determinable annual or periodical income is merely descriptive of the character of a class of income. If an item of income falls within the class it is immaterial whether payment of that item is made in a series of repeated payments or in a single lump sum.

"Fixed" is defined as payable in amounts definitely predetermined. *Id.;* Treas. Reg. § 1.1441-2(a)(2) (1976). "Determinable" is defined as subject to a basis of calculation by which the amount to be paid may be ascertained. *Id.* Finally, income need not be paid annually if it is paid periodically, that is to say, from time to time, whether or not at regular intervals. *Id.*

25. *See* A. Lamm, 34 T.C.M. (CCH) 473 (1975); W.A. Howkins, 49 T.C. 689 (1968); Gerard Trust Corn Exch. Bank v. Comm'r, 194 F.2d 708 (3d Cir.), *cert. denied*, 344 U.S. 821 (1952); Rev. Rul. 283, 1965-2 C.B. 25; Rev. Rul. 53, 1954-1 C.B. 156. *But*

the maturity or surrender of a life insurance policy,[26] royalties,[27] and the earnings of professional athletes[28] have all been found to fall within the general language of section 1441(b).[29] Though prior case law has treated "management fees" as a form of income or gain within the statutory language, no opinion has identified the specific form of income it constitutes.[30] For withholding at the source purposes, the issue may be totally irrelevant, however, for sections 1441 and 1442 draw no distinction (for tax purposes) among such broad classes of income as "compensation," "remuneration," and "fixed or determinable annual or periodic gain, profits and income."[31]

B. *Source Determination Rules*

A second element must also be present for the withholding at the source obligation to arise. In addition to the income or gain being within the general class described in section 1441(b),

cf. Rev. Rul. 108, 1969-1 C.B. 192 (alimony payments to a nonresident alien by a United States ancillary administrator of a nonresident alien estate were not United States source income and were not subject to withholding tax at the source).

26. *See* Rev. Rul. 51, 1964-1 C.B. (Part I) 322 (amounts received by a nonresident alien, from sources within the United States, upon surrender or maturity of a life insurance policy were United States source income).

27. *See* Treas. Reg. § 1.1441-2(a)(1) (1976). *See also* Kimble Glass Co., 9 T.C. 183 (1947); Comm'r v. Celanese Corp., 140 F.2d 339 (D.C. Cir. 1944).

28. *See* Rev. Rul. 503, 1975-2 C.B. 352 (the Service illustrated the tax treatment for amounts earned in the United States by French or British boxers and trainers); Rev. Rul. 107, 1973-1 C.B. 376, *amplifying* Rev. Rul. 543, 1970-2 C.B. 172 (nonresident alien journalist who wrote articles in the United States while under contract to a domestic news service had United States source income); Rev. Rul. 543, 1970-2 C.B. 172 (prize money earned by a nonresident boxer and nonresident professional golfer was United States source income subject to withholding); Rev. Rul. 17, 1955-1 C.B. 388 (that portion of payments for manufacturing "know-how" and personal services performed outside the United States in connection with instruction of employees with respect to such "know-how" is *in the nature of* royalty income and, therefore, subject to withholding of tax at the source).

29. Other forms of income, not mentioned in I.R.C. § 1441(b), but still subject thereto, are: Rev. Rul. 108, 1974-1 C.B. 248 (sign-on fees with a sports team); Rev. Rul. 479, 1958-2 C.B. 60 (prizes, commissions, and winnings at the racetrack).

30. Yardley and Co., Ltd., 11 B.T.A.M. (P-H) ¶ 42,482 (1942) is the only case to date that has discussed the treatment for source-determination purposes of management fees. The opinion, however, never clearly determined what class of income such fees specifically come within (for purposes of I.R.C. §§ 1441, 1442). Such phrases as "remuneration," "compensation," or "gain" clearly seem broad enough, both in the letter and spirit of § 1441 to encompass the concept of management fees.

31. I.R.C. § 1441(b). Section 1441(b) prescribes a general rule for all the forms of income it encompasses. For that reason, it is of little concern which specific form of income management fees constitute. The rule is the same regardless of the classification.

it must also constitute "income from sources *within* the United States."[32] Should the income constitute income from sources without the United States, the withholding at the source requirement of section 1442 is inapplicable.[33]

Generally, the Service's complement of weapons consists of three interrelated provisions. Section 861 defines the concept of United States source income,[34] section 862 defines the concept of foreign source income,[35] and section 863 includes any items not specifically found in the preceding two sections.[36] As with sections 1441 and 1442, none of these sections mentions "management fees."

In contrast to the breadth and sweep of sections 1441 and 1442, however, the very structure of the income source determination provisions negates any argument that "management

32. I.R.C. § 1441(a). The language of the statute is: "[H]aving the control, receipt, custody, disposal, or payment of any of the items of income specified in subsection (b) (to the extent that any of such items constitutes gross income from sources within the United States) . . . ." *See also* Treas. Reg. § 1.1441-1 (1976).

33. *See* Treas. Reg. § 1.1441-3(a) (1976). The regulation states: "To the extent that items of income constitute gross income from sources without the United States, they are not subject to withholding under § 1.1441-1." The regulation then cross references one to the income source determination rules of I.R.C. § 861 *et seq. See generally* Burge, *Current Trends in the Taxation of Multinational Enterprises*, 52 TAXES 746 (1974).

34. I.R.C. § 861. The statute allocates the following items of income to sources within the United States: interest, dividends, personal services compensation, rentals and royalties from property located in the United States, gains from the sale or exchange of realty in the United States, gains from the sale or exchange of personalty purchased without but sold within the United States and certain underwriting income. Treas. Reg. § 1.861-1(a) (1976) notes that the statute specifically allocates these items of income to sources within the United States. In effect, the statute irrebutably presumes that the items of income enumerated are from sources within the United States.

35. I.R.C. § 862. Section 862 briefly states that for each of the items of income enumerated in I.R.C. § 861, if generated without the United States, an irrebutable presumption arises that the income is from sources without the United States. Treas. Reg. § 1.862-1(a) (1976) states: "The following items of gross income *shall* be treated as income from sources without the United States." (Emphasis added.)

36. I.R.C. § 863(a) provides that: "Items of gross income . . . other than those specified in sections 861(a) and 862(a), shall be allocated or apportioned to sources within or without the United States." The final sentence of § 863(a) states that the remainder if any shall be included in full as taxable income from sources within the United States. *Id.* It would appear that this provision may be read as a catch-all. *See* Op. A.G. 5, I-2 C.B. 192 (1922) (the Attorney General opined that damages paid by a domestic corporation to a foreign corporation for breach of a contract were income from sources within the United States because any income from the completed contract would have been income from sources within the United States). Arguably, the last sentence of § 863(a) would have encompassed these facts. *See* notes 70-71 *infra* for the discussion of an analogous question: allocation burden.

fees" may be included within those specific items of income conclusively allocated entirely to either United States or foreign sources by sections 861 and 862.[37] Section 863 specifically states that items of gross income other than those specified in sections 861(a) and 862(a) shall be allocated or apportioned to sources within or without the United States under regulations prescribed by the Secretary.[38]

Though the Commissioner has been empowered to promulgate allocation rules under section 863, he has ony done so with respect to certain businesses such as transportation services and telegraph and cable services.[39] Regulation 1.861-4(b), however, may offer some guidance to the taxpayer attempting to allocate or apportion management services. The regulation states that gross income from sources within the United States includes *compensation for labor or personal services performed in the United States* irrespective of the residence of the payer, the place in which the contract for service was made, or the place or time for payment.[40] The logical questions therefore

37. *See* note 36 *supra*. I.R.C. § 863 expressly requires that income be allocated to its proper source. The statute precludes one from designating an item of income as "substantially" or "predominately" from one source, thereby imposing a duty on the taxpayer to specifically support his alleged allocation of such an item. *See* Le Beau Tours Inter-America, Inc. v. United States, 76-1 U.S. Tax Cas. ¶ 9302 (S.D.N.Y. 1976), whereby the court questioned the continued validity of Comm'r v. Piedras Negras Broadcasting Co., 42-1 U.S. Tax Cas. ¶ 9384 (5th Cir. 1942). The Southern District Court of New York questioned the Fifth Circuit Court of Appeals' allocation of "certain insignificant activities." 76-1 U.S. Tax Cas. ¶ 9302, at 83,693 n.2.

38. I.R.C. § 863(a).

39. The only regulations promulgated to date by the Service under I.R.C. § 863 are primarily concerned with transportation services (Treas. Reg. § 1.863-4 (1976)), the sale of personal property (Treas. Reg. § 1.863-3 (1976)), and communication services (Treas. Reg. § 1.863-5 (1976)). In addition, recent regulations have been proposed under I.R.C. § 861 allowing a taxpayer to treat income from certain aircraft and vessels as income from sources within the United States. *See* Proposed Treas. Reg. § 1.861-9 (1976), 40 Fed. Reg. 30971 (1975).

40. Treas. Reg. § 1.861-4 (1976). The language of the regulation appears to be aimed at the performance of services by a nonresident alien individual. That is exclusive focus of subsection (1) of the regulation. *Id.* § 1.861-4(a)(1). Nowhere in the statute or regulation are foreign corporations specifically mentioned, either as included or excluded from the statute's scope. As will be discussed in the text and accompanying notes 45-73 *infra*, courts have simply assumed that foreign corporations are within the spirit and letter of the statute. The Ninth Circuit expressly addressed this issue, however, in Comm'r v. Hawaiian-Phillipine Co., 100 F.2d 988, 991 (9th Cir.), *cert. denied*, 307 U.S. 635 (1939), when it held that the statute did apply to corporations. *See* note 69 *infra*, for further discussion of the *Hawaiian-Phillipine Co.* decision.

Nonetheless, § 863 has been extensively applied to foreign corporations. The major difficulty that has arisen centers around the issues of by whom, how, and where does become (1) can a corporation perform personal services, and (2) how and where does a corporation perform such services.[41]

For years beginning after December 31, 1975, when services are performed partly within and without the United States, the amount to be included in gross income from sources within the United States shall be determined on the basis that most correctly reflects the proper source of income under the facts and circumstances of the particular case. In many cases, the proper method of allocation will be on a time basis but in other cases another method will be acceptable.[42] In contrast, for taxable years beginning before January 1, 1976, regulation 1.861-4(b)(2) mandates the use of a time basis allocation for services performed partially within and partially without the United States:

> If no accurate allocation or segregation of compensation for labor or personal services performed in the United States can be made, or when such labor or service is performed partly within and partly without the United States, the amount to be included in the gross income shall be determined by an apportionment on the time basis; that is, there shall be included in the gross income an amount which bears the same relation to the total compensation as the number of days of performance of the labor or services within the United States bears to the total number of days of performance of labor or services for which the payment is made.[43]

Regulation 1.863-4(c) also suggests a similar time based method of allocation for the performance of certain transportation services.[44]

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a corporation act? *See* Rev. Rul. 55, 1960-1 C.B. 270, at text and accompanying notes 50-51 *infra;* Rev. Rul. 17, 1955-1 C.B. 388 (payments by a domestic corporation to a foreign corporation for instructing its personnel were not United States source income). *See* note 69 *infra.*

41. That a time basis allocation of personal services by foreign corporations seems logical is a different issue from whether the statute mandates such a method of allocation. *Hawaiian-Phillipine Co.,* 100 F.2d at 991, best summarized the issue by noting that (1) the Commissioner failed to cite any authority for the proposition that corporations could not perform personal services, (2) no reason was advanced for excluding corporations from the reach of the statute, and (3) I.R.C. § 7701 expressly includes a corporation within the definition of person. In any event, a time based allocation of services performed by a corporation, whether they may be classed as personal services or not, appears most logical.

42. Treas. Reg. § 1.861-4(b)(1) (1976).

43. *Id.* § 1.861-4(b)(2). Unfortunately, the regulation gives no indication of what other method of allocation might be permissable for the Service to use.

44. *See* Treas. Reg. § 1.863-4(c) (1976). The regulation allows for the use of a "reasonable method" of apportionment, but suggests a proration based on the propor-

II. CASE LAW

In the management services area, the case law clearly supports the "place of performance" allocation test adopted under regulation 1.861-4(b) for labor and personal services for individuals as well as corporate taxpayers.

In *Appeal of G. H. Salmon*[45] the Board of Tax Appeals expressly sanctioned the "place of performance" test for allocating services within and without the United States. In *Salmon* the taxpayer spent two years in India renovating an Indian factory recently purchased by his New York based employer and claimed that his wages were foreign source income. The Service argued to the contrary and alleged a deficiency only slightly in excess of the $84.00 tax liability calculated by the taxpayer. On review the Board of Tax Appeals concluded that the taxpayer was taxable only upon the portion of the compensation paid him for services rendered within the United States.[46]

In *British Timkin, Ltd. v. Commissioner,*[47] a 1949 Tax Court case, the court again faced the issue of whether fees paid to a foreign corporation constituted United States or foreign source income. In this instance a United States firm sold parts to foreign purchasers who had previously dealt exclusively with a foreign supplier. The domestic corporation received the foreign supplier's permission to sell to the foreign buyers and, in exchange, agreed to pay the foreign supplier a twenty percent

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tion which the number of days the ship was within the territorial waters of the United States bears to the total number of days on the voyage. This method of allocation was explained in Rev. Rul. 495, 1972-2 C.B. 414, *superseding* I.T. 2098, III-2 C.B. 167 (1924). *Compare* Treas. Reg. 1.863-4(c) (1976) *with* Treas. Reg. § 1.863-5(b) (1976) (concerning telegraph and cable services) *and* Treas. Reg. § 1.863-3(c) (allocation of personal property sales income).

45. 3 B.T.A. 838 (1926), *acq.* V-1 C.B. 5 (1926).

46. The Board of Tax Appeals stated: "As a nonresident alien the taxpayer would be taxable only upon such portion . . . as was paid him for *services rendered within* the United States." *Id.* at 839 (emphasis added). Subsequent cases have sanctioned this "place of performance test" for the source allocation of personal services income. *See, e.g.*, William N. Dillin, 56 T.C. 228 (1971), *acq.* 1975-1 C.B. 1 (citing Karrer v. United States, 152 F. Supp. 66, 71 (Ct. Cl. 1957)) (source is determined by the situs of the services rendered, not the location of the payer, residence of the taxpayer, place of contract, or place of payment).

47. 12 T.C. 880 (1949), *acq.* 1949-2 C.B. 1. The petitioner was a British corporation. All of the capital stock of petitioner was purchased by American Timken in 1928. Subsequently, the two corporations executed licensing and trademark agreements. *Id.* at 881.

commission on all such sales.[48] At the time the parties executed their agreement, the domestic firm owned slightly more than fifty percent of the foreign supplier's stock. The court looked closely at the situs of the foreign corporation's services. The factors the court found to be determinative were (1) the foreign corporation maintained no office or place of business in the United States, (2) no officer of such corporation visited the United States, and (3) the foreign corporation was not engaged in a trade or business within the United States.[49] As a result the court concluded that all of the services rendered by the foreign subsidiary had been performed without the United States.

Both the *Salmon* and *British Timken, Ltd.* cases were subsequently cited in Revenue Ruling 60-55.[50] In that instance, a

48. *Id.* at 881-85. The court expressly noted that American Timken could not have sold its bearings to petitioner's distributors and customers without petitioner's consent, unless it chose to violate the territorial sales agreement between the companies. *Id.* at 887.

49. *Id.* at 888. The court held that the source of the petitioner's income was exclusively in the British Empire, which was the situs of the sales activities of the petitioner's agents. In this instance, therefore, the court believed that the corporation acted where its agents conducted business. In support of this allocation, the court cited three earlier decisions. The earliest of the three was Sabatini v. Comm'r, 98 F.2d 753 (2d Cir. 1938), *modifying* 32 B.T.A. 705 (1935). In *Sabatini*, the court held that a nonresident author's income from certain copyrights constituted income from sources within the United States. It is interesting to note that *Sabatini* did not involve personal services but instead focused on the issue of royalty income. *Id.* at 755.

The second decision cited by the *Timken* court was Comm'r v. Piedras Niegras Broadcasting Co., 43 B.T.A. 297 (1941), *aff'd*, 127 F.2d 260 (5th Cir. 1942). In *Piedras*, 95% of a Mexican radio station's income came from United States advertising pursuant to contracts executed at its Mexican office. *Id.* at 301. The court held, however, that because the services were rendered at the point of transmission, all of the services were performed outside of the United States. 127 F.2d at 261. In the opinion of the Board of Tax Appeals, it was expressly noted that there had been no contention that radio broadcasting constituted services rendered partly within and without the United States. 43 B.T.A. at 314. The Fifth Circuit ignored this fact in their majority opinion. Because of this, *Piedras* is of questionable value in regard to the *Timken* Case.

Finally, the *Timken* court cited Korfund Co., 1 T.C. 1180 (1943). The *Timken* court's reliance on *Korfund* is also highly suspect in light of the fact that *Korfund* expressly followed *Sabatini* and distinguished *Piedras* on the ground that *Piedras* did not involve personal services. *Id.* at 1187.

For discussion of the "place of performance" test in a sale of goods setting, see Phillip Bros. Inter-Continent Corp. v. United States, 1966-1 U.S. Tax Cas. ¶ 9421, 85,993-86,005 (S.D.N.Y. 1966).

50. Rev. Rul. 55, 1960-1 C.B. 270. Of primary concern to the Service in this instance, was the fact that the foreign taxpayer corporation maintained its sales and service personnel permanently outside of the United States. The Service cited, with approval, the following passage from *British Timken Ltd.*, 12 T.C. 880, 887:

foreign corporation agreed to solicit purchase orders from foreign buyers for a domestic American corporation. In the event that buyers circumvented the agent or purchased directly from the American corporation, the seller was nonetheless obligated to pay a commission for the foreign corporation's "promotional services." Without extensive analysis the Service concluded that all of the promotional work by the foreign corporation was performed exclusively in foreign countries.[51] Consequently, the fees paid were held to be entirely foreign source income.

Only one case has directly reviewed the issue of "management fees." In *Yardley & Co., Ltd. v. Commissioner*,[52] a British corporation supplied "managerial services" to its United States subsidiary in return for fifteen percent of the subsidiary's profits. The specific services performed by the parent corporation were (1) arranging for shipment to the subsidiary of foreign source materials, (2) maintenance of a research laboratory, (3) exclusive laboratory testing and experimentation, (4) all advertising and art work, and (5) general consultation on policy matters.[53] The domestic subsidiary, two years after the "management fees" arrangement had been executed, formally identified in the minutes of a board of directors meeting the above-mentioned services as the basis for the "management fees."[54]

> [W]e do not regard the fact that the situs of the sales was within the United States as determinative of the source of petitioner's income . . . . It is the situs of the activity or property which constitutes the source of the compensation paid and not the situs of the sales by which it is measured that is of critical importance.

Id. at 271.

51. The Service noted that the commissions paid in recognition of the fact that the sales would not have been made except through the services of the taxpayer and that any promotion so performed was done exclusively in foreign countries. *Id.* at 271-72. Though unclear, there appeared to be some ownership relationship between the foreign and domestic entities. The ruling was vague on this point.

52. 11 B.T.A.M. (P-H) 1219 (1942).

53. *Id.* at 1222, 1225. The shipment arrangements concerned shipments from British and various other foreign ports. *Id.* The testing laboratory was located in Britain. *Id.*

54. *Id.* at 1224. The only documentation of the nature of the services rendered by the foreign corporation to the domestic subsidiary rested in some hastily drawn meeting minutes. The specific resolution adopted by the board of directors stated that the payments were made "in consideration of the use of the name 'Yardley,' and of other good and valuable considerations." *Id.* At trial, the Secretary of the domestic subsidiary testified that it was really the intention of the directors to focus on the other good and valuable considerations and that use of Yardley's name was an erroneous expression. *Id.* The president of the American corporation testified that he understood

The Board of Tax Appeals concluded that ninety percent of the British corporation's services were performed without the United States.[55] Without explaining the basis for this precise allocation, the Board appears to have adopted the exact percentage allocation suggested by the chairman of the board of Yardley and Co., Ltd.,[56] the taxpayer.

Subsequent cases have elaborated only slightly on the method for allocating services to within and without the United States. In 1973, the Tenth Circuit reversed and remanded *Tipton & Kalmbach, Inc. v. United States*.[57] In *Tipton & Kalmbach*, a Colorado corporation contracted to perform engineering services incident to the design and construction of certain canals in West Pakistan. Two of the taxpayer's principal officers spent sixty to eighty percent of their time working in the taxpayer's Denver office.[58] In attempting to support its contention that fees generated were foreign source income, the taxpayer relied heavily on *Commissioner v. Piedras Negras Broadcasting Co.*,[59] where the Fifth Circuit held that advertis-

the payment to have simply arisen as an ordinary charge by the foreign parent corporation. *Id.* For further elaboration of the testing services performed *see* 11 B.T.A.M. (P-H) at 1226. Mr. Pitt, one of the directors of the British corporation, testified that the fees merely covered "services rendered and travelling expenses." *Id.* at 1225.

55. *Id.* at 1227.

56. *Id.* at 1226-27. It is difficult, looking at the opinion alone to determine exactly how the Board came to so precise an allocation of services to within and without the United States. The Board stated: "We are convinced that a maximum of 10 percent of the services for which the payments in question were made were rendered in the United States and that the remaining 90 percent were rendered by the British Corporation in England." *Id.* at 1226. The Board never specifically identified those services that were rendered within the United States, nor the method of allocation that resulted in such services accounting for ten percent of the total. The Board never discussed a time basis allocation method, or any other method, for that matter. Consequently, the opinion is of some guidance in identifying those elements of managerial services that lend themselves to source allocation under I.R.C. §§ 861-863, but the opinion offers little assistance in identifying the actual allocation method.

57. 73-2 U.S. Tax Cas. ¶ 9541 (S.D.N.Y. 1973).

58. The taxpayer's services were performed by expatriate personnel in Pakistan, Pakistan nationals, and employees in the taxpayer's Denver office. Messrs. Tipton and Kalmbach spent approximately 20 to 40 percent of their time in Pakistan. The remainder of their time was spent in the Denver office. *Id.* at 81,727. The court did not indicate the nature of the work performed by these men while in the Denver office. *Compare* Tipton & Kalmbach, Inc., 73-2 U.S. Tax Cas. ¶ 9541, *with* Yardley, 11 B.T.A.M. (P-H) 1219 (in *Tipton* as opposed to *Yardley*, the court was less concerned with the nature of the services rendered and more concerned with the manner of allocation. *Id.* at 81,728).

59. 43 B.T.A. 297, *aff'd*, 127 F.2d 260 (5th Cir. 1942). See the discussion of the *Piedras* majority opinion in note 49 *supra*. The *Tipton* court attempted to distinguish the *Piedras* decision on the ground that in *Piedras* all of the services were held to have

ing fees paid by Americans to a Mexican based radio station represented income generated wholly from services performed outside the United States. Though a minor amount of activities were rendered within the United States, the Fifth Circuit attributed *all* of the income to that country where the predominant service, broadcasting, was performed.[60]

In *Tipton & Kalmbach*, the Tenth Circuit distinguished the decision in *Piedras Negras* on the basis that *no* United States source services were performed in that case.[61] The Service advocated a payroll basis method of allocation of the taxpayer's services.[62] The district court indirectly supported the Service's position by finding that the taxpayer had failed to establish its right to a method of allocation *other* than the payroll cost basis.[63] Citing regulation 1.861-4(b) concerning labor and personal services and noting that the taxpayer's ex-

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been rendered outside of the United States, while in *Tipton*, some services were concededly performed within the United States. 73-2 U.S. Tax Cas. at 81,728. The *Tipton* court, in an indirect reference to *Piedras*, stated: "Furthermore, Code sections 861(a)(3) and 862(a)(3) do not attribute all of a taxpayer's income to the country where most of its services are performed." *Id.*

60. *See* note 49 *supra*. In this early allocation case, the dissent clearly appeared to be approaching an interpretation of I.R.C. §§ 861-863 more consistent with the present interpretation of those provisions. The dissenting opinion of Judge McCord noted that (1) many of Piedras' programs originated from a Texas based studio, (2) programs were aimed at American listeners, (3) 95 percent of the advertising income came from United States citizens, (4) Piedras' agents solicited funds in the United States, (5) contracts were entered into within the United States, (6) Piedras availed itself of American banks, and (7) a United States mail address was maintained. 127 F.2d 261-62. In spite of the numerousness of these "contacts" within the United States, the majority opinion elected to ignore these factors and focus exclusively on the issue of where the actual transmissions originated. *Id.* at 261.

61. *See* notes 59 and 60 *supra*. The *Piedras* decision stands as questionable support in all allocation cases because the Board of Tax Appeals noted that the decision was argued on an "all-or-nothing" basis, without any discussion of the possibility of allocation. 43 B.T.A. at 314. *See* note 49 *supra*.

62. The Service took the position that the income generated by the services performed should have been apportioned between United States and Pakistani sources in the same proportions as were the taxpayers' payroll costs. 73-2 U.S. Tax Cas. at 81,729. The basis for such an allocation method, in the Service's opinion, was that source allocation would be more accurate. *Id.*

63. 72-2 U.S. Tax Cas. ¶ 9563 (D. Colo. 1972). The court noted: "Section 1.861-4(b) of the Treasury Regulations on Income Tax [concerning personal services source allocation] was not intended to apply to service-performing corporations." *Id.* at 85,304. The court then shifted the burden to the plaintiff-taxpayer to show that it was entitled to a different method of allocation than the payroll cost method supported by the Service. *Id.* at 85,306. In effect, the district court gave the Service carte blanche authority to use whatever method of source allocation maximized tax liability.

hibits contained sufficient uncontroverted figures to utilize the time basis allocation, the Tenth Circuit reversed and remanded the case, stating that

> [n]either system of allocation [time or payroll] can reflect with complete exactness the amount of taxable income and consequently we hold that the Internal Revenue Service should abide by its own regulations [time basis allocation] when they are not in conflict with an express statutory provision.[64]

In March 1976 in *Le Beau Tours Inter-America, Inc. v. United States,*[65] the Southern District Court of New York found the continued validity of *Piedras Negras Broadcasting Co.* questionable in light of the *Tipton & Kalmbach* decision.[66] In *Le Beau Tours* the taxpayer alleged that the arrangement and packaging of foreign tours took place in Latin America by means of direct and personal contact with the foreign hotels. In examining the facts the court found that the taxpayer's selecting, administering, and supervising of tours in Latin America were services performed outside of the United States. To the degree, however, that the plaintiff carried on these activities within the United States, United States source income was being generated.[67] In a footnote the court noted that a substantial portion of the taxpayer's income-generating activities, such as developing packaged tours and providing assistance to American tourists, was performed within the United States.[68]

64. *Id.* at 81,728. More specifically, the Tenth Circuit Court of Appeals noted that: "The Internal Revenue Service is thus not free to apply an *ad hoc* method of allocation when Treas. Reg. § 1.861-4(b) does not abuse the allocation issue in this case." 73-2 U.S. Tax Cas. at 81,729. A long line of precedent supports the proposition that if the taxpayer is bound by a regulation, the Service is equally bound. *See* Brofman v. United States, 67-2 U.S. Tax Cas. ¶ 12 494, at 85,644 (5th Cir. 1967); Miller v. Comm'r, 333 F.2d 400, 403 (8th Cir. 1964); McCord v. Granger, 201 F.2d 103, 107 (3d Cir. 1952); Pacific Nat'l Bank v. Comm'r., 91 F.2d 103, 105 (9th Cir. 1937); Warner Bros. Pictures, Inc. v. Westover, 70 F.Supp. 111, 115 (S.D. Cal. 1947). *See generally* MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 3.20 (1942).

65. 76-1 U.S. Tax Cas. ¶ 9302 (S.D.N.Y. 1976).

66. The Court stated "*Commissioner v. Piedras Negras Broadcasting Co., supra,* whatever its validity after *Tipton and Kalmbach* is in conflict with the decision here." *Id.* at 83,693 n.2.

67. The court noted: "While this court does not believe that the plaintiff can properly be considered a wholesale seller of hotel space and tours, . . . the plaintiff is engaged in a service business in which services are performed both in the United States and abroad." *Id.* at 83,692. The specific services performed by the taxpayer were: (1) personal inspections of hotels, (2) developing total tour packages, (3) maintaining representatives in foreign countries to assist tourists, and (4) selecting, administering, and supervising tours. *Id.* at 83,692-93.

68. The court said: "Here it appears that a fairly substantial portion of the activi-

In retrospect the only clear pattern discernible from these allocation cases is that the taxpayer bears a heavy burden of proof.[69] Should the taxpayer fail to substantiate his alleged allocation of services to a specific source, he faces the possibility that such services will be classified as performed wholly or predominantly *within* the United States.[70] In *Sax Rohmer* just

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ties which generated Le Beau Inter-America's income—as distinguished from that of its local hotel and tour operators—took place in the United States." *Id.* at 83,693 n.2.

69. The source allocation of income from services performed by a corporation has arisen in various other decisions, also. *See* Comm'r v. Hawaiian Phillipine Co., 100 F.2d 988, 991 (9th Cir.), *cert. denied,* 307 U.S. 635 (1939) where the court noted that the time basis allocation of services performed by a corporation was within both the letter and spirit of the personal services income allocation guides of I.R.C. §§ 861-863 (at that time I.R.C. § 119(c)). It is interesting to note that *Hawaiian Phillipines* received only passing mention in an obscure footnote in the *Piedras Negras* decision, 127 F.2d at 261 n.2. For further elaboration on the *Hawaiian Phillipines* decision *see generally* Annot. 160 A.L.R. 559, 589 n.5 (1946).

For other instances of corporate performed services falling under the concept of source allocation *see, e.g.,* Yokohama Ki-Ito Kwaisha, Ltd., 5 B.T.A. 1248, 1256-57 (1927) (a foreign corporation which took orders for, or entered into contracts for the sale of, silk in the United States, through an agent in the United States, received income from within the United States to the extent of the difference between the selling price and its cost); Comm'r v. East Coast Oil Co., 85 F.2d 322, 323 (5th Cir.), *cert. denied,* 299 U.S. 608 (1936) (where a Mexican corporation negotiated for the sale of Mexican oil to United States businesses, but the title to the property passed at the place of shipment and delivery occurred in Mexico, the fact that the payments were made in the United States did not change the status of this income as generated by services performed outside of the United States).

See also Rev. Rul. 154, 1976-1 C.B. 191 (compensation paid a domestic corporation by a foreign country for property of the domestic corporation previously expropriated was held to be income from sources without the United States); Rev. Rul. 198, 1971-1 C.B. 210 (income of a foreign corporation from the sale of tuna caught in international waters to United States canners was income from sources without the United States); Rev. Rul. 194, 1967-1 C.B. 183 (income of a foreign corporation from the sale of mineral ore extracted in the foreign corporation's homeland to United States buyers, through an independent agent located in the United States is income from sources without the United States).

For a generalized discussion of the above issues *see generally* Brigg & Hufbauer, *Expropriation Losses and Tax Policy,* 16 HARV. INT'L L.J. 533 (1975); Caplin, *Trading With Related Foreign Entities: Current American Tax Perspective,* 9 AKRON L. REV. 223 (1975).

70. Where there is no basis upon which an allocation or apportionment of income to sources within and without the United States can be made, the full amount must be deemed to be from sources within the United States. In short, the taxpayer carries the burden of proof concerning allocation. *See, e.g.,* Wodehouse v. Comm'r., 177 F.2d 881, 883 (2d Cir. 1949); Molnar v. Comm'r, 156 F.2d 924 (2d Cir. 1946); Rohmer v. Comm'r, 153 F.2d 61 (2d Cir.), *cert. denied,* 328 U.S. 862 (1946); Estate of Alexander Marton, 47 B.T.A. 184 (1942). Particular attention should be paid to Misbaurne Pictures, Ltd. v. Johnson, 189 F.2d 774 (2d Cir. 1951) (the appellants presented no basis upon which to allocate income, so the entire amount was allocated to United States sources).

such an all-or-nothing allocation was imposed upon a taxpayer who failed to substantiate his claimed allocation of lump sum payments between United States source and Canadian source serial rights to stories published by the taxpayer in both countries.[71]

The case law and revenue rulings concerning the proper source allocation of foreign corporation-performed management services is meager. Because such a determination is primarily a factual issue, one may anticipate a willingness on the Service's part to contest such allocations between related corporate entities. A foreign corporation not engaged in a trade or business within the United States is taxed at a rate of thirty percent only on its United States source income.[72] Again, if management fees constitute the foreign parent's only income from the United States, a successful allocation of such services to sources wholly outside the United States will preclude the parent from incurring any United States income tax liability.[73] It is not surprising, therefore, that the Service may refuse to let the related corporations' source allocation go unchallenged.

III. UNITED STATES-CANADIAN INCOME TAX TREATY

Section 894 of the Code provides that income of any kind, to the extent required by any treaty obligation of the United States, shall be exempt from taxation.[74] In addition, section 7852(d) states that no provision of the tax code shall apply where its effect would be contrary to any treaty of the United States.[75]

The United States-Canadian Income Tax Treaty has been subject to numerous modifications and supplements since its signing in 1942.[76] Numerous provisions of the treaty exempt

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71. Rohmer v. Comm'r, 5 T.C. 183 (1945), *aff'd.*, 153 F.2d 61 (2d Cir.), *cert. denied*, 328 U.S. 862 (1946). It is interesting to note that all of the cases in note 70 *supra* were concerned with the taxpayers' allocations of serial rights to publications or movies. *See also* Note, *Taxation of Income from Literary Property Owned by Nonresident Aliens*, 54 YALE L.J. 879 (1945).

72. *See* note 7 and accompanying text *supra*.

73. *Id.*

74. I.R.C. § 894. The United States has signed tax treaties with over 40 different countries. For a brief synopsis of each treaty *see* [1977] 5 STAND. FED. TAX REP. (CCH) ¶ 4200 *et seq.*

75. I.R.C. § 7852(d).

76. Convention Between the United States and Canada Respecting Double Taxation, *supra* note 20. For an additional source where the entire United States-Canadian Income Tax Treaty may be found, *see* [1977] 5 STAND. FED. TAX REP. (CCH) ¶ 4222-24.

certain income earned by Canadian taxpayers in the United States from United States taxation in an attempt to minimize the possibility of double taxation of the taxpayer.[77] Summarizing various provisions of the treaty, regulation 519.102 exempts "industrial and commercial profits of a Canadian enterprise having no permanent establishment in the United States" from United States taxation.[78] Additionally, regulation 519.103(a) provides that the mere fact that a Canadian parent corporation has a domestic subsidiary in the United States shall not constitute the maintenance of a "permanent establishment" in the United States by that Canadian parent.[79] Any

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For a discussion of the treaty and its impact, *see generally* Brown, *Canada-United States Tax Relations*, 28 TAX. EXEC. 1 (1975); McKie, *U.S.-Canadian Tax Treaty*, 66 PROC. NAT'L TAX A.-TAX INST. AMERICA 67 (1973); Mullens, *The Tax Treaty Between Canada and the USA: A U.S. Viewpoint*, 27 TAX EXEC. 53 (1974); Patrick, *U.S.-Canadian Tax Treaty*, 66 PROC. NAT'L TAX A.-TAX INST. AMERICA 67 (1973); Stileman, *The Tax Treaty Between Canada and the U.S.A.: A Canadian Viewpoint*, 27 TAX EXEC. 52 (1974).

77. The following classes of income have been exempted from taxation by other than its state of incorporation: (1) industrial and commercial profits (article I), 56 Stat. at 1399, T.S. No. 983, [1977] 5 STAND. FED. TAX REP. (CCH) at 48,023; (2) certain income from the operation of ships or aircraft (article V), 56 Stat. at 1401, T.S. No. 983, [1977] 5 STAND. FED. TAX REP. (CCH) at 48,024; (3) wages or salaries paid by governmental entities (article VI), 56 Stat. at 1401, T.S. No. 983, [1977] 5 STAND. FED. TAX REP. (CCH) at 48,024-25; (4) annuities (article VIA), 2 U.S.T. at 2237, T.I.A.S. No. 2347, [1977] 5 STAND. FED. TAX REP. (CCH) at 48,025; (5) certain forms of personal services compensation (amended article VII), 8 U.S.T. at 1621-22, T.I.A.S. No. 3916, [1977] 5 STAND. FED. TAX REP. (CCH) at 48,025-26; (6) sales or exchanges of capital assets (article VIII), 56 Stat. at 1402, T.S. No. 983, [1977] 5 STAND. FED. TAX REP. (CCH) at 48,026; (7) visiting professors' income (article VIIIA), 2 U.S.T. at 2238 T.I.A.S. No. 2347, [1977] 5 STAND. FED. TAX REP. (CCH) at 48,026; (8) funds to maintain students (article IX), 56 Stat. at 1402, T.S. No. 983, [1977] 5 STAND. FED. TAX REP. (CCH) at 48,026; (9) income derived by charitable organizations (article X), *id.* Various other forms of income are also exempt, *e.g.*, directors' fees (article XIIIB), royalties (article XIIIC), 2 U.S.T. at 2239-40, T.I.A.S. No. 2347, [1977] 5 STAND. FED. TAX REP. (CCH) at 48,028-29. For a brief discussion of the interrelationship of management fees and the United States-Canadian Tax Treaty from a Canadian tax perspective *see generally* O'Keefe, *Management Fees and Withholding Tax*, 23 CAN. TAX. J. 130 (1975).

78. 56 Stat. at 1399, T.S. No. 983, [1977] 5 STAND. FED. TAX REP. (CCH) at 48,023. *See specifically* 26 C.F.R. § 519.102 (1976) *reproduced in* [1977] 5 STAND. FED. TAX REP. (CCH) at 48,035. The specific language of the regulation is: "Industrial and commercial profits of a Canadian enterprise having no permanent establishment in the United States." *Id.*

79. 26 C.F.R. § 519.103(a) (1976), [1977] 5 STAND. FED. TAX REP. (CCH) at 48,037. For a discussion of the "commercial and industrial profits" concept and the "permanent establishment" concept *see* Donray, Ltd. v. United States, 301 F.2d 200, 208 (9th Cir. 1962) (Canadian corporations which are limited partners in a United States partnership maintain a permanent establishment within the United States);

hope, however, that management fees earned by a Canadian corporation might fall within this exemption is clearly negated by regulation 519.103(d), which provides that "industrial and commercial profits" are those profits arising from "industrial, mercantile, manufacturing, or like activities of a Canadian enterprise"; fees or charges for managerial activities are expressly excluded from the definition of "industrial and commercial profits."[80]

Regulation 519.105[81] provides for a "time basis" allocation

Comm'r v. Consolidated Premium Iron Ores, Ltd., 265 F.2d 320, 324-25 (6th Cir. 1959) (a foreign corporation did not have a United States permanent establishment when it had no assets in the United States, maintained no United States bank accounts, had no real United States office and had not delegated to anyone in the United States power to execute contracts); F. Handfield, 23 T.C. 633, 638 (1955) (an individual residing in Canada who effected the sale of Canadian-made post cards through an American distributor had a permanent establishment in the United States); Rev. Rul. 562, 1973-2 C.B. 434, 435 (interest received from borrowers in the United States by a Canadian bank did not qualify as industrial or commercial profits); Rev. Rul. 263, 1965-2 C.B. 561, 561-62 (maintenance of United States offices to solicit business for a Canadian corporation to be performed in Canada constituted a permanent establishment in the United States); Rev. Rul. 113, 1963-1 C.B. 410, 411 (a United States corporation which purchased goods on consignment from a Canadian corporation did not constitute a permanent establishment in the United States); Rev. Rul. 282, 1955-1 C.B. 634, 635 (a Canadian corporation having an agent in the United States with discretionary authority to buy or sell has a United States permanent establishment).

80. 26 C.F.R. § 519.103(d) (1976), [1977] 5 STAND. FED. TAX REP. (CCH) at 48,037.

81. 26 C.F.R. § 519.105 (1976), [1977] 5 STAND. FED. TAX REP. (CCH) at 48,039. The regulation provides that:

> Except as provided in section 119(a)(3) of the Internal Revenue Code, gross income from sources within the United States includes compensation for labor or personal services performed within the United States regardless of the residence of the payor, of the place in which the contract for service was made, or of the place of payment. If a specific amount is paid for labor or personal services performed in the United States, such amount (if income from sources within the United States) shall be included in the gross income. If no accurate allocation or segregation of compensation for labor or personal services performed in the United States can be made, or when such labor or service is performed partly within and partly without the United States, the amount to be included in the gross income shall be determined by an apportionment on the time basis, i.e., there shall be included in the gross income an amount which bears the same relation to the total compensation as the number of days of performance of the labor or services within the United States bears to the total number of days of performance of labor or services for which the payment is made.

For further discussion of the allocation of personal services income under the Treaty, *see* Rev. Rul. 66, 1976-1 C.B. 189, 190 (salary paid a Canadian hockey player of compensation for labor or personal services performed partly within and partly without the United States by a Canadian individual that is almost identical to that found in regulation 1.861-4(b)(2).[82] The treaty provisions do not appear to apply to corporate-performed services, and it is difficult to determine if this provision was so drafted purposely or inadvertently.

An alternative argument for excluding management services from United States taxation may exist under article XII(B) of the treaty. The provision states that "director's fees" paid by a corporation to a director residing in one of the contracting states for services at directors' meetings held in the "other" controlling state shall be exempt from tax by the "other" state.[83] Though superficially appealing, the taxpayer subsidiary must overcome the following weaknesses inherent in such an argument: (1) directors' fees are not defined by the statute; (2) directors' fees are paid directly to directors, while management fees are usually paid to the parent corporation; and (3) often management services are performed primarily by nondirector experts and technicians. Thus, it appears that none of the exemptions created by the United States-Canadian Income Tax Treaty were meant to encompass "management fees."[84]

IV. SUGGESTED TAX PLANNING TECHNIQUES

In light of the inability to bring United States source "management services" fees within any of the United States-

by a United States team which plays some games in Canada is income partly from within and partly from without the United States); Rev. Rul. 330, 1957-2 C.B. 1013, *modifying* Rev. Rul. 24, 1956-1 C.B. 851 (allocation of employees' income for transportation services rendered partly within and partly without the United States); Rev. Rul. 119, 1954-1 C.B. 156, 157 (income of a Canadian corporation from personal appearances of an entertainer in the United States is not personal services income, but rather exempt commercial or industrial profits).

82. *See* text and accompanying notes 39-44 *supra*.

83. *See* 2 U.S.T. at 2239-40, T.I.A.S. No. 2347, [1977] 5 STAND FED. TAX REP. (CCH) at 48,028-29.

84. Merely finding that none of the exemptions in the United States-Canadian Income Tax Treaty apply to management fees does not automatically subject the Canadian parent and domestic subsidiary to the withholding at the source requirements of I.R.C. § 1442. If so alleged, the Service must carry the burden of proof that the foreign corporation fraudulently failed to file a return. *See* note 11 *supra*. *See also* I.R.C. § 7454(a). In those cases, however, where the Service has only alleged failure to file a return, the taxpayer must carry the burden of proving that the Service's deficiency calculation is incorrect. *See, e.g.*, King Tsak Kwong, 12 T.C.M. (CCH) 1136, 1140 (1953); Broadcast Measurement Bureau, Inc., 16 T.C. 988 (1951).

Canadian Income Tax Treaty exemption provisions, foresighted tax planning in such transactions is an absolute necessity. Of greatest value to the taxpayer is preventative tax planning aimed at avoiding any question as to where management services were performed. Reactive, post-transaction tax advice often can do little to mitigate or lessen the tax impact of an already-completed transaction. Unfortunately, all too often tax questions are not recognized until after they become tax problems.

A. *Management Fee Payment Planning*

Although not precluding a contest by the Service, pretransaction preventative tax planning coupled with extensive documentation will certainly place the management fee-paying domestic subsidiary in a more defensible position. If any lesson may be learned from the *Yardley* case,[85] it is that the taxpayer must carry his burden of proof as to the allocation of services within and without the United States.

Consequently, prior to the adoption of a management services arrangement, the following items should be extensively documented in the minutes of the board of directors meetings of both the subsidiary and the parent corporations:

1. The management services agreement should be embodied in a formal written contract.[86]

85. *See* 11 B.T.A.M. (P-H) at 1222-27. The taxpayer had numerous witnesses testify on its behalf. The witnesses were the domestic subsidiary's accountant, president, and other officers. Such testimony was supplemented by numerous pieces of correspondence. *See also* notes 70-71 and accompanying text *supra*.

86. The purpose served by a written management services agreement is primarily an evidentiary one. Not that only in *British Timken Ltd.*, 12 T.C. at 880, 881-83, and Rev. Rul. 55, 1960-61 C.B. at 271, were the taxpayers foresighted enough to reduce their agreements to written contracts. In both those instances, the court and the Service found, in accordance with those agreements, that none of the foreign corporation's services were performed in the United States. *Compare Le Beau Tours*, 76-1 U.S. Tax Cas. at 9302, *with Tipton & Kalmbach, Inc.*, 72-2 U.S. Tax Cas. at 85,304-05, where the court noted that written agreements executed by the parties were highly explicit concerning the allocation of services to particular sources. *See also Yardley and Co., Ltd.* 11 B.T.A.M. (P-H) at 1223, where the Board noted that it was unclear whether the management services agreement was written or oral. In those cases where the petitioner is successful in his claimed services allocation, the courts have focused on the existence and terms of the written agreements. *See British Timken, Ltd.*, 12 T.C. at 887; Rev. Rul. 55, 1960-1 C.B. at 271. In *Yardley and Co., Ltd.*, 11 B.T.A.M. (P-H) at 1225-26, the Board found a plethora of other documentation to support its findings. In those cases where the plaintiff is unsuccessful in its proposed allocation, the courts make no mention of the terms of the contracts. *See Le Beau Tours*, 76-1 U.S. Tax Cas. at 83,692-93; *Tipton & Kalmbach, Inc.* 73-2 U.S. Tax Cas. at 81,727-28. Without

> 2. The formula used in calculating the management fee should be clearly identified.[87]
> 3. If possible, the corporation should avoid tying management fees to gross or net profits. Preferably, fees should be tied to a time basis allocation method.[88]
> 4. Fees should be determined in advance of the beginning of the corporation's fiscal year.[89]
> 5. If possible, there should be documentation of comparable fees paid by comparable companies for comparable services.[90]
> 6. The management services agreement should clearly identify the nature of the services to be performed and the specific location where such services are to be performed.[91]

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attributing more to these distinctions than they merit, at the very least, it may noted that written contracts executed by a foreign parent and its domestic subsidiary would be of some evidentiary value.

87. Not only should the formula be identified, it should also adhere closely to the time basis allocation method outlined in Treas. Reg. § 1.861-4(b)(2) (1976). By anticipating problem areas under such an allocation method, careful drafting may serve to reduce potential attacks by the Service. In *Yardley and Co., Ltd.*, the Board accepted and adopted the taxpayer's own method of allocation. 11 B.T.A.M. (P-H) at 1226-27. *Compare* Wodehouse v. Comm'r, 117 F.2d at 883, where the court cited the following language of the Tax Court: "The parties to the contract were best able to make a proper allocation and segregation of the respective values. They neglected or chose not to do so," but held instead that the taxpayer's agent's testimony was sufficient, *with* Rohmer v. Comm'r, 153 F.2d at 65, where the court simply noted that the taxpayers, who had the burden, offered *no direct proof* on the allocation issue. The obvious benefit of a reasonable method of allocation, adopted by the parties in a written agreement, is its effect on the Service's burden of going forward.

88. One of the primary dangers in tying "management services fees" determinations to a percentage of some form of profits, is that the fees begin to resemble actual or constructive dividends. *See* I.R.C. §§ 301, 316. Under I.R.C. § 861(a)(2), dividends received from a domestic corporation are presumptively allocated to sources within the United States, in their entirety. *See also* Treas. Reg. § 1.861-3(b) (1976). Though there are exceptions and mitigations of this "all-or-nothing" rule, it is much safer to simply avoid any question that management fees might constitute dividends.

89. This strategy should be implemented to avoid any of the problems attendant upon a reclassification of management services fees as dividends. *See* note 88 *supra*.

90. In *Yardley and Co., Ltd.*, the domestic subsidiary's president testified that: "even if they [the management services] could have been obtained in the United States . . . [it] 'would have undoubtedly cost us more than the 15 percent we pay London.'" 11 B.T.A.M. (P-H) at 1228. In short, such a search for comparable domestic services and the negative results therefrom may be some evidence that only foreign sources remained as available suppliers. In light of the location test adopted for personal services under I.R.C. § 861 and its regulations, indirect support in this manner may be of some assistance. *See* Rohmer v. Comm'r, 177 F.2d at 883.

91. *See* note 87 and accompanying text *supra*. In *Yardley and Co., Ltd.*, the

7. Arm's length attempts at employing an independent party to perform similar services should be documented, if made.[92]

8. Finally, the agreement should contain a provision whereby interest is charged on the "management fee" account's outstanding balance.[93]

B. *Operational Stage Planning*

In addition to preventative tax planning prior to entering into a management services agreement, certain steps or policies may be implemented during the life of the contractual relationship between the related business entities that will bolster the assertion that management services were performed wholly or predominantly outside of the United States. At this stage, the maintenance of accurate and complete records is an absolute necessity. The following procedures will constitute persuasive evidence in support of the taxpayer's allocation:

1. Steps 1 through 8 of the previous section should be performed, if not already done.[94]

2. Any amendments to the agreement must be formally adopted, and the reason for the amendment should be clearly documented.[95]

3. Fees incurred must be actually paid or accrued with interest.[96]

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taxpayer eventually identified the services, with great specificity, that the foreign parent corporation performed. 11 B.T.A.M. (CCH) at 1225-26. *See also British Timken, Ltd.*, 12 T.C. at 887, 888, where the court identified and examined the specific services rendered by the foreign corporation to the domestic entity.

92. *See* notes 89 and 90 and accompanying text *supra.*

93. *Id.*

94. In *Yardley and Co., Ltd.*, a formal resolution identifying the specific services that were being compensated for was not adopted until June 5, 1930, but the actual payments began sometime in 1928. 11 B.T.A.M. (P-H) at 1223-25. Consequently, even "midstream" documentation, when supported by other evidence may be sufficient grounds upon which the taxpayer may substantiate his alleged allocation.

95. *See* text and accompanying notes 86-93 *supra.* Again the formal resolution adopted in *Yardley and Co., Ltd.*, on June 5, 1930, had as its primary purpose the correction of the earlier 1928 minutes where the domestic corporation designated use of the name Yardley as the *quid pro quo* for the 15 percent of profits payment to the foreign corporation. 11 B.T.A.M. (P-H) at 1224-25. *See* note 54 *supra.*

96. This function is more a requirement of the nature of deductible payments than it is a question of an income source allocation. *See* I.R.C. § 162(a)(1) and Treas. Reg. § 1.162-7 (1976). *See* First Nat'l Benefit Society v. Comm'r, 8 T.C.M. (CCH) 841, 847, *aff'd per curiam*, 183 F.2d 191 (9th Cir. 1950) (cash basis taxpayer must deduct compensation payments when actually paid); Vander Poel, Francis & Co., 8 T.C. 407, 410-12 (1947) (only salary actually paid is deductible). *But cf.* Globe-Gazette Printing Co.,

4. The following records accurately reflecting time spent on subsidiary, as opposed to parent, related business must be maintained:
   (a) employee time cards,[97]
   (b) trips by parent officers to the subsidiary's offices,[98] and
   (c) phone bills and research time spent resolving issues raised during these calls.[99]

5. Inventory and supply records must accurately reflect the above-outlined components.[100]
6. Preferably, meetings and visits should be held at the parent's offices and not at the subsidiary's.[101]

C. *Post-Deficiency Notice Planning*

The "post-deficiency notice" period may be the most difficult time frame within which to build support for one's contention that a Canadian parent's managerial services were performed wholly or predominantly without the United States. It

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16 B.T.A. 161, 165-66 (1929) (If taxpayer is on the accrual method, actual payment is not a prerequisite. The salary is only deductible during the year in which it accrued.)

97. The use of employee time cards is one method of documentation readily available to the corporate taxpayer and also perfectly consistent with the time based allocation method of I.R.C. § 861 and Treas. Reg. § 1.861-4(b)(2) (1976). *See* notes 42 and 43 and accompanying text *supra.*

98. The travel by executive officers to the domestic corporation's plant in the United States, twice a year, in *Yardley and Co., Ltd.*, appeared to be the major service rendered by the British parent within the United States. 11 B.T.A.M. (P-H) at 1226. *See also* Comm'r v. Piedras Negras Broadcasting Co., 42-1 U.S. Tax Cas. 356, 357 (5th Cir. 1942) (McCord, J., dissenting) (the dissent stressed the numerous activities actually performed by the taxpayer or its agents in the United States). *But cf. Tipton & Kalmbach, Inc.*, where the Tenth Circuit rejected a payroll cost method of allocation urged by the Service. 73-2 U.S. Tax Cas. at 81,728. Instead the court required the Service to apply the time method of allocation outlined in the regulations. *Id.*

It is important to note here that often the actual physical time spent within the United States will be minimized when compared to the time allocated to services rendered outside of the United States.

99. Phone bills are another method of allocation based on "time." It must not be forgotten, however, also to include all the hours spent by foreign personnel at the foreign corporation's office resolving any problems raised during these phone calls.

100. *See, e.g., Yardley and Co.*, Ltd., 11 B.T.A.M. (P-H) at 1222, 1225. *See also* Comm'r v. East Coast Oil Co., 85 F.2d 322, 323 (5th Cir.), *cert. denied,* 299 U.S. 608 (1936).

101. *See* note 98 *supra.* This appears to be one way to eliminate the major element of United States source services: advice rendered during trips to the domestic subsidiary's plant or offices. When "location" is as crucial to a transaction's source determination as it is under I.R.C. §§ 861-863, the loss of a travel expenses deduction under I.R.C. § 162(a)(2) is a small price to pay for the foreign parent.

must be remembered, however, that even partial documentation of the source of the services will be helpful. Section 863 clearly indicates that the taxpayer may prove partial allocation of management services under the income source provisions.[102]

Assuming the entities had not anticipated income source allocation problems, the worst possible situation occurs when the statute of limitations on the Canadian tax liability has run, but the statute has not run on the American subsidiary's return.[103] In such a situation, the Service may allege that the management services were performed wholly within the United States, and therefore the American subsidiary should have withheld at the source on such fees.[104] If the Service is successful, the related group will be faced with double taxation: a thirty percent withholding at the source tax on the subsidiary as well as Canadian corporate income tax liability on the parent. Other less onerous but nonetheless serious double taxation possibilities may arise, depending on when the taxpayers become aware of their position.[105]

Fortunately, various administrative procedures have been developed to minimize the possibility of international double taxation. The United States-Canadian Income Tax Treaty specifically provides in Articles IV[106] and XVI[107] for an administrative mechanism known as the "competent authority."[108] In the

102. *See* notes 39-69 and 85-101 and accompanying text *supra.*

103. The potential for such a situation is not unlikely. Except in cases of fraud or misrepresentation, the Canadian Minister must notify any taxpayer in writing of a deficiency within four years from the day the tax was due. Can. Stat., Act to Amend the Income Tax Act, c. 63, § 152(4) (1971). In contrast, the Internal Revenue Service may assess the tax at any time if the taxpayer has filed a false or fraudulent return or failed to file a return at all. I.R.C. § 6501(c)(1)-(3). *See* note 12 *supra.*

104. *See* notes 21-33 and accompanying text *supra.* In this instance, if the statute of limitations had run on the Canadian tax return, but no American return was filed, the Service could assess a withholding at the source tax against the domestic subsidiary.

105. If the assessment by the Service occurs within four years of the date that the Canadian return was filed, a refund could be requested by the foreign parent from its taxing authority. Can. Stat., Act to Amend the Income Tax Act, c. 63, § 164(1)-(3) (1971).

106. Convention Between the United States and Canada Respecting Double Taxation, *supra* note 20.

107. *Id.*, 56 Stat. at 1404.

108. The competent authorities were designated in the Protocal to the Tax Treaty as the Commissioner and the Minister and their duly appointed representatives. (Protocal § 4). *Id.*, 56 Stat. at 1408. The "competent authority" procedures have recently been the subject of much literature, *see* Cole, *Competent Authority Procedure: Inter-*

United States the competent authority function is bifurcated into the Assistant Commissioner Compliance and the Assistant Commissioner Technical.[109] By treaty the United States competent authority and his foreign counterpart are empowered to negotiate arrangements minimizing or eliminating double taxation.[110]

Revenue procedures 70-18[111] and 77-16[112] outline the steps to be followed by a taxpayer in requesting competent authority assistance. Revenue procedure 70-18 is exclusively concerned with the possibility of double taxation arising from section 482 reallocations,[113] while revenue procedure 77-16 is concerned with double taxation arising from the availability to a United States taxpayer of credits, exemptions, reduced tax rates, or other benefits provided under an income tax treaty.[114] Though the question of the determination of the source of a particular item of income does not fall squarely within the categories addressed by either of these rulings, the procedures outlined should offer the taxpayer some guidance.

The competent authority alternative is not free from draw-

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national Tax Counsel Gives His Views, 35 J. TAX. 8 (1971); Hanlon, *The Competent Authority: Settlement of International Tax Disputes*, 1975 TAX ADVISER 4; O'Donnell, *A Provision-By-Provision Analysis of Rev. Proc. 70-18: Many Questions Remain*, 35 J. TAX. 12 (1971); Pergament and Auderieth, *The "Competent Authority" Rules for Section 482 Relief: An Analysis of Rev. Proc. 70-18*, 35 J. TAX. 2 (1971); Comment, *The Competent Authority Concept in United States Tax Treaties*, 2 LAW & POL. INT'L BUS. 232 (1970).

109. *See* Hanlon, *supra* note 108, at 4.

110. See Convention Between the United States and Canada Respecting Double Taxation, *supra* note 20. By January of 1975, 68 cases had been referred to the United States competent authority and 60 had resulted in full relief from double taxation. Hanlon, *supra* note 108 at 7-8.

111. Rev. Proc. 18, 1970-2 C.B. 493.

112. Rev. Proc. 77-16, 1977-19 I.R.B. 35.

113. Section 1. The Purpose and Scope of Rev. Proc. 70-18 states that it is concerned exclusively with allocation of income questions. 1970-2 C.B. at 493. The Revenue Procedure then outlines the procedures to be followed where the treaty country proposes the allocations, *Id.* at 494-96, and the procedures to be followed where the Internal Revenue Service proposes the allocations. *Id.* at 496-97. The Procedure also outlines the general responsibilities of the competent authority. *Id.* at 498.

114. Rev. Proc. 77-16, 1977-19 I.R.B. 35 outlines the procedures whereby a taxpayer may present his request for relief from double taxation, *id.* at 35-37, and the procedures to be followed by the competent authority, *id.* at 37-38. Section 7 recognizes that taxpayers of the United States may request advance rulings as an alternative to the competent authority procedures. *Id.* at 38. Section 1, Purpose and Scope of the Procedure, makes it clear that Rev. Proc. 77-16 was not meant to encroach in any way on the problems addressed by Rev. Proc. 70-18. *Id.* at 35.

backs. Many questions have been left unanswered even by the revenue procedures. First, the criteria for acceptance of a case by the competent authority have not been published.[115] Second, all the taxpayer may request is "consideration"; the granting of consideration by the competent authority does not guarantee relief from double taxation.[116] Finally, the question remains as to what relief, if any, the taxpayer will be afforded if the competent authorities fail to agree.[117] Though the Service (through the competent authority) has demonstrated a willingness to help taxpayers facing potential double taxation, preventative tax planning may eliminate the need to rely on the ambiguous and uncertain competent authority procedures developed in recent years.

CONCLUSION

The relative paucity of case law and revenue rulings in the area of income source determination of foreign parent-performed management services is no indication of the importance of the issue. Management services agreements are a valuable tax planning tool for both the subsidiary and the parent corporation. However, the ramifications of poorly planned or

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115. Prior to the release of Rev. Proc. 70-18 Commissioner Thrower had identified three criteria for acceptance by the competent authority: (1) the economic double taxation issue had to have been established and fully explored at the administrative level; (2) an informal agreement had to exist between the Service and the United States taxpayer as to how much of a settlement would be acceptable; and (3) the request had to merit consideration. O'Donnell, *supra* note 108, at 14. One finds no mention of the criteria for acceptance in either Rev. Proc. 70-18 or Rev. Proc. 77-16. *See* notes 111-112 *supra*.

116. Pergament and Auderieth, *supra* note 108, at 4. *See* Rev. Proc. 70-18, 1970-2 C.B. at §§ 5.01, 5.02 and 9.01. *See also* Rev. Proc. 77-16, 1977-19 I.R.B. at §§ 2.02, 4.03 and 6; Cole, *supra* note 108, at 9-10.

117. It would appear that the taxpayer is left with his other alternative administrative and judicial remedies. *See* 1970-2 C.B. at 498 (sec. 9.04); 1977-19 I.R.B. at 38 (sec. 6.04). O'Donnell has noted that: "Unless the taxpayer's foreign affiliate is successful in any legal action, if any it is able to bring in the foreign country, the taxpayer appears to be eternally burdened with a double taxation situation." O'Donnell, *supra* Note 108, at 13-14. See also Pergament and Auderieth, *supra* note 108, at 4 (taxpayer is limited to his administrative and judicial remedies if he refuses to accept the competent authorities' compromise or if the competent authority refuses to consider the case). Hanlon has noted however that as of January 1975, 68 cases had been closed by the competent authority, in which 60 resulted in full relief from double taxation, four in partial relief, and four without relief due to procedural barriers. Hanlon, *supra* note 108, at 7-8. Hanlon concludes: "In short, the record demonstrates our overall success in resolving these issues. Only a small number of cases were closed without relief to the taxpayers, and this was caused by a procedural barrier, not a breakdown in negotiations." *Id.* at 8.

unplanned management services agreements may have a twofold effect: unanticipated recognition of United States source income and, even more deleterious, subjection to potential double taxation.

This article has attempted to identify those procedures that may be implemented by related corporations to minimize the possibility of United States source income recognition or double taxation. Because the structure of the income source provisions permits partial income source allocation, every attempt to document the source of every possible management service performed should be made at the earliest possible date. In conclusion, the relationship of parent corporation and subsidiary is such that because of the ever-present concern for avoiding even the appearance of a section 482 non-arm's-length transaction, many of the procedures and forms of documentation advocated by this article will entail little additional preparation, if any. Consequently, the implementation of these procedures will prepare the taxpayers for, if not protect them from, Service scrutiny of parent-subsidiary management services agreements under sections 861 through 864 of the Internal Revenue Code.

Foreign-Trade Zones: Sub-Zones, State Taxation, and State Legislation

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I. INTRODUCTION

This article proposes to address the topics of sub-zones, state taxation, and state legislation as they relate to foreign-trade zones. Before embarking upon a detailed treatment of these topics, however, it may be appropriate to discuss briefly certain general characteristics of foreign-trade zones.

Foreign-trade zones are facilities created under the Foreign-Trade Zones Act[1] (hereinafter referred to as the Act) for the purpose of expediting and encouraging foreign commerce. The Act provides for the creation of a Foreign-Trade Zones Board[2] consisting of the Secretary of Commerce, the Secretary of the Treasury, and the Secretary of War.[3] The Board is authorized, *inter alia,* to grant to qualified applicants[4] "the privilege of establishing, operating, and maintaining foreign-trade zones in or adjacent to ports of entry under the jurisdiction of the United States."[5]

Perhaps the most frequently cited definition of a foreign-trade zone is that contained in the regulations[6] promulgated by the Foreign-Trade Zones Board:

> It [a foreign-trade zone] is an isolated, enclosed, and policed area, operated as a public utility, in or adjacent to a port of entry,

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1. Foreign-Trade Zones Act of 1934, ch. 590, 48 Stat. 998-1003 (1934), *as amended,* 19 U.S.C. §§ 81a-u (1976).
2. *Id.* § 81a(b).
3. *Id.* The Secretary of the Army is now the third member of the Foreign-Trade Zones Board replacing the now defunct office of the Secretary of War. 15 C.F.R. § 400.103 (1977).
4. *Id.* § 81a(g).
5. *Id.* § 81b(a).
6. 15 C.F.R. §§ 400.100-.1406 (1977).

> furnished with facilities for lading, unlading, handling, storing, mainipulating [sic], manufacturing, and exhibiting goods, and for reshipping them by land, water, or air. Any foreign and domestic merchandise, except such as is prohibited by law or such as the Board may order to be excluded as detrimental to the public interest, health, or safety may be brought into a zone without being subject to the customs laws of the United States governing the entry of goods or the payment of duty thereon; and such merchandise permitted in a zone may be stored, exhibited, manufactured, mixed or manipulated in any manner, except as provided in the act and other applicable laws or regulations. The merchandise may be exported, destroyed, or sent into customs territory from the zone, in the original package or otherwise. It is subject to customs duties if sent into customs territory, but not if reshipped to foreign points.[7]

As this definition suggests, "The ability to defer or eliminate payment of customs duties is the traditional incentive for sending goods to a foreign trade zone for storage or manufacture."[8]

The foreign-trade zone is one component of the temporary entry system established under Title 19 of the United States Code.[9] The drawback, the bonded warehouse, and the temporary importation bond, constitute the other three components of the system.[10] Like the foreign-trade zone, each of the three offers some relief from payment of customs duties.

The drawback permits a merchant to "drawback," (that is, to reacquire) up to ninety-nine percent of the duties paid on imported goods, if the goods imported are later exported.[11] The drawback procedure is helpful principally in those cases in which a merchant imports goods for use in the manufacture of a product for export. The chief disadvantages of the drawback are the initial capital outlay for payment of duties on the items imported, the quite burdensome paperwork necessary to implement the drawback procedure, and the delay in collection of the drawback payments.

Bonded warehouses for storage and for manufacture are also available to importers.[12] Duties are not assessed on goods

7. *Id.* § 400.101 (1977).

8. Landy & McGinnis, *Foreign Trade Zones in Florida: Legal Considerations for Foreign Business Interests*, 10 LAW. AM. 141, 142 (1978).

9. *See* note, *Foreign Trade Zones: Hole in the Tariff Wall or Incentives for Development?*, 2 LAW & POL'Y INT'L BUS. 190, 191 (1970).

10. *Id.*

11. 19 U.S.C. § 1313 (1976).

12. *Id.* § 1311.

in a bonded warehouse until they leave the bonded warehouse and enter United States Customs Territory.[13] However, a bond must be paid both for the warehouse facility, and for the individual goods imported.[14] A bonded warehouse has an advantage over the drawback system in that the duty on an imported product is never levied if the product is reexported. However, the problem of the initial capital outlay is not solved in its entirety, since payment of bond is required. Additionally, the bonded warehouse procedure, like the drawback procedure, involves burdensome paperwork and, moreover, constant Customs supervision is required.[15] A final disadvantage is the three-year time limit after which goods may no longer remain in the bonded warehouse.[16]

Temporary importation bonds permit a manufacturer to import goods without paying customs duties, provided that the goods are repaired, altered, or processed and then exported.[17] The advantage of this procedure is that manufacturing can take place outside a bonded warehouse without payment of full customs duties as required by the drawback procedure. The disadvantages of the temporary importation bond are strict Customs supervision, the time limit in which the final product must be exported,[18] and the required bond.[19]

In an attempt to alleviate some of the administrative and financial burdens of the drawback, the bonded warehouse, and the temporary importation bond, Congress created the foreign-trade zone. The zone, although operated under constant U. S. Customs Service supervision, does not require immediate payment of customs duties or initial expenditures for bonds. In addition, the administrative procedures associated with zone use are far simpler than those required for the utilization of the other components of the temporary entry system.

II. SUB-ZONES

In 1952 the Foreign-Trade Zones Board amended its regulations to authorize "special-purpose sub-zones" in addition to

13. 19 U.S.C. § 1555 (1976).
14. *Id.*
15. 19 U.S.C. §§ 1311, 1555, 1562 (1976).
16. 19 U.S.C. § 1557(a) (1976).
17. 19 U.S.C. § 1202, subch. 8, pt. 5, subpt. C, item 864.05 (1976).
18. *Id.* at item 862.20.
19. *Id.*

the "general-purpose zones" already authorized by the Act.[20] Businesses which qualify under this provision avoid relocating their export operations to an existing zone. Instead, they simply secure the area of their plant or warehouse which will comprise the sub-zone, and follow the same procedural regulations enacted for the general-purpose zones. The only distinction between the two types of zones is that sub-zones, unlike general-purpose zones, are used by only one firm. They are not accessible to other companies wishing to operate under foreign-trade zone status. In fact, they were specifically designed for companies unable to relocate to, or take advantage of, an existing general-purpose zone.[21]

The importance of the sub-zone provisions has grown as more companies which cannot use existing zones seek the benefits of the Foreign-Trade Zones Act. This section will discuss the problems which may be encountered by companies planning to apply for a grant of sub-zone status.

The application procedure for sub-zones is similar to that for general-purpose zones. A public or private corporation[22] must submit an application detailing the "location and qualifications of the area in which it is proposed to establish a zone."[23] However, in the case of sub-zones, an application cannot be submitted unless either a general-purpose zone application has also been submitted or a general-purpose zone has already been authorized.[24] In addition, the applicant for the sub-zone must

20. 15 C.F.R. § 400.304 (1977).

21. Da Ponte, *Foreign-Trade Zones: An Update*, AM. IMPORT & EXPORT BULL., April, 1977.

22. The applicant is usually a public corporation as defined in 19 U.S.C. § 81a(e) (1976):

> [A] State, political subdivision thereof, a municipality, a public agency of a State, political subdivision thereof, or municipality, or a corporate municipal instrumentality of one or more States.

A private corporation is defined in 19 U.S.C. § 81a(f):

> [A]ny corporation (other than a public corporation) which is organized for the purpose of establishing, operating, and maintaining a foreign-trade zone and which is chartered under special Act enacted after June 18, 1934, of the State or States within which it is to operate such zone.

23. 19 U.S.C. § 81f(a)(1) (1976).

24. The regulation states that sub-zones may be established in "an area separate from an existing zone," 15 C.F.R. § 400.304, thereby necessitating the existence of a general-purpose zone. However, the Board has accepted simultaneous general-purpose zone and sub-zone applications. 42 Fed. Reg. 22,391 (1977).

be the same corporation which applied for, or is the grantee of, the general-purpose zone.[25] A company cannot be the applicant for its own sub-zone but must request the general-purpose zone applicant or grantee to apply for a sub-zone in its behalf.[26]

Once the application is submitted, the Board analyzes the information and holds hearings on the proposal.[27] The Board is authorized to "make the grant"[28] if it "finds that the proposed plans and location are suitable,"[29] the "facilities and appurtenances . . . are sufficient,"[30] and that "existing or authorized zones will not serve adequately the convenience of commerce with respect to the proposed purposes."[31] An additional standard, not appearing in the statute or the regulations, but used by the Board, is whether the applicant can show a "specific public benefit" brought about by establishment of the sub-zone.[32] Companies which are planning to develop a sub-zone should be especially concerned with meeting both the location requirement (as used to insure that the sub-zone lies "in or adjacent to" a customs port of entry)[33] and the public benefit test. Neither criterion is clear in practice, but both must be understood prior to the application process.

The location requirement is implied from the relationship of the sub-zone regulation to the Act. The Foreign-Trade Zones Act authorizes the Foreign-Trade Zones Board "to grant to corporations the privilege of establishing . . . foreign-trade zones *in or adjacent to* ports of entry . . . ."[34] (Emphasis added.) The regulation states that sub-zones may be established "in an area separate from an existing zone."[35] The language in the regulation can be interpreted to extend the bound-

25. Da Ponte, *supra* note 21.

26. *Id.* The restriction is implied since section 400.304, which authorizes sub-zones, does not indicate who may apply, thereby leaving this area to the section of the Act and regulations which specify who may apply for a grant. In addition, sub-zones are considered to be extensions of the general-purpose zone, not independent zones.

27. 15 C.F.R. § 400.605 (1977).

28. 19 U.S.C. § 81g (1976).

29. *Id.*

30. *Id.*

31. 15 C.F.R. § 400.304 (1977).

32. Da Ponte, *supra* note 21.

33. 19 U.S.C. § 81b(a) (1976).

34. *Id.*

35. 15 C.F.R. § 400.304 (1977).

aries of the area in which sub-zones can be located. However, by permitting sub-zones "in an area separate from" the general-purpose zone, the Board was referring to its conception of sub-zones as nonadjacent additions to general-purpose zones. Sub-zones were authorized not to extend the area for site location, but rather to meet the needs of individual companies which were "in or adjacent to" customs ports of entry but were unable to use the general-purpose zone.

Colorado offers an example of the problems encountered in interpreting the definition of "in or adjacent to" the port of entry. The only port of entry in Colorado is Denver.[36] The Denver port of entry is established by statute and roughly corresponds with the city limits of Denver.

The definition of "adjacent to" the customs port of entry is, as yet, unclear. Some commentators have suggested that "adjacent to" allows a general-purpose zone or a sub-zone to be located in any county adjacent to the county within which the port of entry lies. This would supposedly help insure that the U.S. Customs Service would not be prevented from supervising any zone operations because of distance problems. However, in Colorado this interpretation would allow zones to be constructed sixty miles from Denver in Arapahoe County, yet not be constructed in Boulder, only thirty miles away.

The regulations offer support for a different interpretation of "adjacent to," based upon the ability of surrounding areas to sustain a foreign-trade zone. An important consideration of the Board when evaluating applications is whether the proposed zone will "adequately serve the convenience of commerce."[37] In order to serve the "convenience of commerce" a foreign-trade zone must be located in an area with, *inter alia*, an adequate transportation network[38] and a regional economy which can support a foreign-trade zone.[39] The logical sites for establishment of foreign-trade zones, including sub-zones, are large urban areas. "Adjacent to" could be defined to be the

36. 19 U.S.C. § 2, Annex A, Sch. D (1976).

37. 15 C.F.R. § 400.304 (1977).

38. 15 C.F.R. § 400.402(b) (1977) requires proof of adequate warehouse space, transportation connections, and power facilities.

39. The application entails an economic survey of the area in order to: "demonstrate . . . that the anticipated commerce, benefits, and returns, both direct and indirect, will justify its construction to expedite and encourage foreign commerce." 15 C.F.R. § 400.400 (1977).

next adjacent urban area, subject to reasonable distance constraints.[40] The closest urban areas to Denver with over 50,000 in population are Colorado Springs and Boulder. If "adjacent to" were interpreted to mean the "next adjacent urban area" then both cities would qualify as potential sites for additional general-purpose zones or sub-zones.

The Boonville, Missouri application for a general-purpose zone, filed in September of 1978, offers precedent for the "next adjacent urban area" interpretation of "adjacent to" a customs port of entry.[41] Boonville is not in a county adjacent to the Kansas City port of entry. However, as of November 1, 1978, the Boonville zone had not been authorized. Yet, an internal opinion written by counsel in the office of the Foreign-Trade Zones Board supports the Boonville application by arguing for the "next adjacent urban area" interpretation of "adjacent to" the port of entry.[42] If the application is approved, it will do much to liberalize the current standard.

If a firm is reasonably certain that it lies "in or adjacent to" a customs port of entry, it must then determine whether it can show a "public benefit" resulting from sub-zone operations. Sub-zones cannot be authorized solely on the basis of profit to the sub-zone user. Rather the sub-zone must benefit the economy in general, such as through "retention of jobs that would otherwise be overseas."[43]

Actually the public benefit test is no more than proof of a condition presumed to be present in general-purpose zones. The Foreign-Trade Zones Act was enacted to help alleviate problems with bonded warehouses and drawbacks in order "to expedite and encourage foreign commerce."[44] In order to determine whether the Act's purpose would be met, the application requires preparation of an economic survey.[45] This survey must not only determine whether foreign commerce will be encouraged but also take into consideration the effect upon "the U.S. balance of payments." Congress was attempting to prevent the

40. An internal opinion in the office of the Foreign-Trade Zones Board supports this interpretation. Telephone conversation with John J. Da Ponte, Jr., Executive Secretary, Foreign-Trade Zones Board (September 11, 1978).

41. 43 Fed. Reg. 44,876 (1978).

42. Telephone conversation, *supra* note 40.

43. Da Ponte, *supra* note 21.

44. 48 Stat. 998 (1934).

45. 15 C.F.R. § 400.400 (1977).

Foreign-Trade Zones Act from becoming a tool for foreign companies to the detriment of domestic business.

The public benefit test for sub-zones fulfills the same function as the economic survey in the application. The test requires the applicant to prove that the sub-zone will encourage foreign commerce and favorably affect the balance of payments. In addition, the test is useful to both applicants and the Board in that it underscores the importance of showing benefits to the public where special arrangements are being made for a particular company.

The most significant challenge to date against the establishment of sub-zones and the Foreign-Trade Zones Act arose in *Armco Steel Corp. v. Stans.*[46] This action was commenced in federal district court by Armco Steel Corporation (Armco) which sought a declaratory judgment to set aside an order by the Foreign-Trade Zones Board authorizing the Board of Commissioners of the Port of New Orleans (New Orleans Board) to operate a sub-zone. The sub-zone was to be located at a shipyard owned by Equitable-Higgins Shipyard, Inc. (Equitable). Equitable intervened in the action, joined by Central Gulf Steamship Corporation (Central Gulf). The district court granted Equitable's and Central Gulf's motion for summary judgment. On appeal the district court's judgment was affirmed.

The events which led to the lawsuit originated with a contract between Equitable and Central Gulf. Under the contract Equitable was to supply Central Gulf with 233 barges.[47] These barges were to be manufactured out of steel plates imported from Japan. Equitable would normally pay duty on the imported steel upon entry of the steel into U.S. customs territory. Since barges entered U.S. customs territory duty-free, Equitable could avoid payment of any duty on the steel by manufacturing under foreign-trade zone status. However, the shipyard was not next to the operating general-purpose zone and could

46. 303 F.Supp. 262 (S.D.N.Y. 1969), *aff'd* 431 F.2d 779 (2d Cir. 1970).

47. The barges were to be used aboard LASH vessels which were high-speed cargo ships equipped with cranes to pick up and carry light barges. The barges could travel inland waterways, pick up cargo, return to the port of entry, and then be transferred onto the LASH ship. These barges would then be transported aboard the LASH vessel to foreign ports of entry, and then unloaded to travel along inland waterways to discharge their goods and pick up new goods.

not be economically moved. The sub-zone provision offered Equitable its only access to the benefits of the Foreign-Trade Zones Act.

Armco's motion for summary judgment rested heavily on three of its five arguments in which it claimed that:

> 1) . . . .
> 2) The Order nullifie[d] the tariff laws and enable[d] Equitable to evade customs duties;
> 3) the sub-zone [could not] be operated as a "public utility," as required by the Act, since it [would] be used solely by a private corporation; [and that]
> 4) the Zones Board's findings of fact [were] insufficient and [were] not based on substantial evidence;[48]
> 5) . . . .

The first of these contentions referred to the concern that the Act would become a "hole in the tariff wall" in that Equitable could avoid duty payment on importation of foreign goods used in the manufacture of the barges. The court deferred to Congressional determination that this was a "consideration of national policy."[49] In this decision, Judge Bonsal, District Judge in the original action, recognized that the Act was designed to alleviate custom obligations in order to promote foreign trade, and that this was typically an executive decision. Armco's argument was premised on the necessity for absolute protection of domestic manufacturers through tariff laws. It failed to acknowledge the contribution the Act provides by permitting domestic companies to lower costs by avoiding certain duties and encouraging foreign companies to utilize American labor and warehousing facilities.

During lengthy debates on the bill which subsequently became the Foreign-Trade Zones Act,[50] the House discussed the possible effects on domestic commerce which later concerned the court in *Armco.* Those opposing the bill feared that foreign-trade zones would permit the lower priced foreign products to be dumped into the United States in competition with domestic commerce. Congressman Cullen, a proponent of the bill, disagreed. Foreign-trade zones would benefit domestic commerce, he stated, not hinder it. In support of his argument,

48. 303 F.Supp. at 268.
49. *Id.*
50. 78 CONG. REC. 9778 (1934).

he quoted from a letter written by the president of the Chamber of Commerce of the United States who wrote:

> [The Chamber of Commerce believes] that . . . American merchants and manufacturers will benefit in a variety of ways from the advantages of a wide American consignment market for foreign products; that the free zones will bring needed improvements in American port and terminal facilities; that the free zones will bring added business to American banks, insurance companies, freight forwarders, and warehousemen; that free zones will bring about a vast improvement of the type of facilities provided at present only by bonded warehouses and drawbacks together with a simplification and saving in the work of customs administration.[51]

The public benefit test responds to the concern in *Armco* and in the House debates that the Act may damage domestic commerce in its attempt to "expedite and encourage foreign trade."[52] The test requires the Board to assess the overall impact on the economy which would result from the operation of a proposed sub-zone. It prohibits the Board from granting a sub-zone if, for example, jobs would be lost to foreign countries with no offsetting benefit to the domestic economy.

Armco's second argument questioned the ability of the sub-zone operator to manage the sub-zone as a public utility, as required by the Act.[53] A profit-seeking company could not fall within the definition of a public utility under Armco's interpretation of the statute. The court dispensed with this contention by addressing the issue of whether other firms were denied the same ability to operate as a sub-zone. The court assumed that the public utility requirement was satisfied through compliance with customs regulations. Quoting the Foreign-Trade Zones Board regulations, the court held that the New Orleans Board was obligated to provide sub-zone status under like conditions.[54] The important factor was whether the Board or the grantee could discriminate between companies asking for sub-zone status. If so, the Act could be used against portions of domestic industry instead of as a tool to encourage foreign trade. Since the court read in a requirement of impar-

51. 78 CONG. REC. 9768 (1934).

52. *See* 303 F.Supp. at 268.

53. 19 U.S.C. § 81n requires: "[E]ach zone [to be] operated as a public utility, and all rates and charges for all services or privileges within the zone [to] be fair and reasonable."

54. 303 F.Supp. at 270.

tiality in permitting sub-zone grants, access to the Act's benefits was open to all qualifed companies.

The third challenge to the Equitable sub-zone claimed that the Board's findings were insufficient. In order to grant a sub-zone the Board must find that "existing or authorized zones will not serve adequately the convenience of commerce with respect to the proposed purposes."[55] However, the Board found enough evidence to satisfy this criterion since employment would increase, more goods would be shipped through the Port of New Orleans, and the sub-zone would help reduce the balance of payments deficit.[56]

On appeal the Second Circuit upheld the lower court, discussing the impact of the sub-zone on domestic industry and on the balance of payments.[57] The court recognized that United States steel producers would lose the competitive protection afforded by tariffs if the sub-zone were established. However, the overall effect on American steel producers would be negligible since the shipbuilding industry consumed only one percent of domestic steel. As for the balance of payments, there would be a flow of cash out of the country if Central Gulf decided to contract with foreign shipbuilders.[58] The sub-zone benefits would encourage construction within the United States, and only the steel would be purchased on a foreign market.

The public benefit test addresses the same issues which concerned the courts in *Armco.* Both *Armco* and the test focus on the economic effect of a sub-zone. The Act was designed to bolster trade. If the sub-zone's benefits are limited to the operators of the sub-zone, it contradicts the Act's intent. However, if the applicant shows that domestic employment will increase or that the balance of trade will improve, then the Board might be more disposed to order the grant.

Sub-zone 33A offers an example of the procedure a company must undertake in order to obtain a grant from the Board.[59] In April of 1977 the Regional Industrial Development Corporation of Southwestern Pennsylvania (RIDC) submitted

55. 15 C.F.R. § 400.304 (1977).
56. 303 F.Supp. at 270.
57. 431 F.2d 779 (1970).
58. *Id.* at 785.
59. 42 Fed. Reg. 22,391 (1977).

an application requesting a grant authorizing it to establish a general-purpose zone in Allegheny County and a special-purpose sub-zone in Westmoreland County. The Pittsburgh customs port of entry was located primarily in Allegheny County, but extended into Westmoreland County, thereby allowing both zones to meet the requirement that they be "in or adjacent to" a customs port of entry.

The sub-zone was to encompass a portion of an automobile assembly and manufacturing plant owned by Volkswagen Manufacturing Corporation of America (Volkswagen). Since RIDC was the applicant for the general-purpose zone, it was necessary for it to apply for the sub-zone on behalf of Volkswagen.

Volkswagen had negotiated for sub-zone status for its plant because it had determined that it would be paying duties at a rate of 3% within the sub-zone, as opposed to 4.2% without the sub-zone. However, the benefits of the sub-zone were not limited to Volkswagen. Once operations started, Volkswagen planned to employ up to 5,000 people, and it estimated a secondary impact of 20,000 additional jobs in the region. Volkswagen also indicated that it might not operate a United States plant without foreign-trade zone status. The public benefit test was satisfied since the sub-zone would significantly increase employment.

III. STATE AND LOCAL TAXATION OF FOREIGN-TRADE ZONES

While the Foreign-Trade Zones Act exempts goods in foreign-trade zones from customs duties, it does not specifically exempt such goods from state and local taxation. Whether state and local taxes[60] apply is of obvious importance to businesses in determining whether they should move the goods they import and export through foreign-trade zones.

Export/Import Clause

Under the Export/Import Clause of the United States Constitution, a state may not impose "imposts" or "duties" on

60. Henceforth referred to simply as "state taxation." For example, it is at present unclear whether such state taxes as sales taxes (COLO. REV. STAT. § 39-26-101 to 126), and use taxes (COLO. REV. STAT. § 39-26-201 to 211), or such local taxes as sales taxes (DENVER, COLO., REV. MUNICIPAL CODE § 166), and use taxes (DENVER, COLO., REV. MUNICIPAL CODE 166A), would apply to goods within a zone located in Colorado.

exports or imports.[61] However, as a result of *Michelin Tire Corp. v. Wages*[62] the clause almost certainly does not prohibit a state from taxing goods held in a foreign-trade zone. In *Michelin* the Supreme Court held that a nondiscriminatory ad valorem property tax "is not the type of state exaction which the Framers of the Constitution . . . had in mind as being an 'impost' or 'duty' under the Export/Import Clause.[63] Therefore, as long as the state tax on items in a foreign-trade zone is nondiscriminatory, meaning goods outside the zone are taxed on the same basis as goods in the zone, the Export/Import Clause does not present an impediment to the state taxation of products stored or processed in a foreign-trade zone.

However, it might be argued that if the goods in the foreign-trade zone are intended for export, then a nondiscriminatory state tax is in the nature of an impost or duty. The tires in the *Michelin* case (upon which the state tax levies were permitted) were no longer in transit, a fact specifically acknowledged by the Supreme Court.[64] As discussed below, courts will frequently make reference to whether goods are or are not intended to come to rest in the United States, without stating precisely how that affects the decision.

Commerce Clause

The Commerce Clause gives Congress plenary authority over both interstate and foreign commerce.[65] States may not discriminate against foreign commerce,[66] or infringe upon the federal regulation of foreign commerce.[67] Therefore, if the state taxation of goods in a foreign-trade zone is held to be discriminatory with respect to foreign commerce, or is held to be an intrusion upon the federal government's regulation of that commerce, it will be disallowed.

Foreign Commerce/Relevant Cases

Neither the Foreign-Trade Zones Act, nor the regulations thereunder, states that goods in foreign-trade zones are in for-

61. U.S. CONST. art. 1, § 10, cl. 2.
62. 423 U.S. 276 (1976).
63. *Id.* at 283.
64. *Id.* at 302.
65. U.S. CONST. art. 1, § 8, cl. 3, as interpreted in California Bankers Ass'n v. Shultz, 416 U.S. 21 (1974).
66. *See* Nippert v. City of Richmond, 327 U.S. 416 (1946).
67. *See* McGoldrick v. Gulf Oil, 309 U.S. 414 (1940).

eign commerce. However, since goods in a zone are exempt from United States customs duties,[68] and since goods in a foreign-trade zone are intimately connected with foreign commerce, and further since Congress desired to encourage foreign commerce by the passage of the Foreign-Trade Zones Act,[69] there would seem to be no fundamental difference between goods in a zone and goods in foreign commerce. In *McGoldrick v. Gulf Oil*[70] the Supreme Court indicated it might support such a view. This case involved an attempt by the state of New York to tax oil located in a bonded warehouse. The oil in the bonded warehouse had been imported and was intended, after processing, for export. The court pointed out that the Congressional exemption of the oil from United States taxation was a valid exercise of Congress' power to regulate foreign commerce and that the state tax on the oil would be an "infringement of the Congressional regulation of the commerce."[71] Since, as previously pointed out, a foreign-trade zone is in part intended to have a similar function to that of a bonded warehouse, it could be argued that goods in a foreign-trade zone, but which are intended for export, should be exempt from state taxation under *McGoldrick*.

During v. Valente,[72] while not a tax case, contains reasoning similar to that of *McGoldrick*. In *During* the defendant hired the plaintiff to obtain purchasers for foreign liquor stored in the New York foreign-trade zone. The plaintiff alleged that the defendant breached his contract, and it was maintained in defense that the plaintiff had no cause of action because he had not received a permit to sell liquor as required by New York law. The New York court held that "[the] zone was created under the power of Congress to *regulate commerce with foreign nations*" which "power is exclusive and plenary."[73] (Emphasis added.) The court went on to state that the mere "geographical location of the goods within the state of New York did not constitute an import into the state," citing *McGoldrick*.[74] The court added that the imposition of the licensing requirement

68. 19 U.S.C. § 81c (1976).

69. Purpose Clause to the Foreign-Trade Zones Act, 48 Stat. 998 (1934) [hereinafter cited as Purpose Clause].

70. 309 U.S. 414 (1940).

71. *Id.* at 429.

72. 267 App. Div. 383, 46 N.Y.S.2d 835 (1944).

73. *Id.* at 387.

74. *Id.*

would be a burden on foreign commerce and interfere with Congress' exclusive control over such commerce. However, the court also pointed out that the complaint contained no allegation that the sale involved the importation of liquor *into* the state of New York, thereby maintaining the distinction between goods in a zone intended for export and goods in a zone intended for entry into United States customs territory.

In *American Smelting & Refining Co. v. County of Contra Costa,*[75] a California appellate court permitted the state to impose a nondiscriminatory tax on metal inventories in a bonded warehouse. The case is, however, of dubious explanatory value with respect to the state taxation of goods in a foreign-trade zone. The California court emphasized the special nature and background of smelting and refining warehouses,[76] and specifically held that the law covering foreign-trade zones was not controlling,[77] and suggested that the Foreign-Trade Zones Act may be a "broader statute" than the statute authorizing bonded warehouses.[78] The court, however, also stated that the inventories in the bonded warehouse in question were not irrevocably destined for foreign commerce.[79] Thus, here too the destination of the good is emphasized.

The Final Destination

Whether goods in a foreign-trade zone should be treated differently for state taxation purposes may depend upon whether the goods will be exported or enter United States customs territory. An argument may be made for the proposition that the goods should not receive different treatment, and thus state taxes should not apply in either case. It should be recalled that "persuasive reasons" are required before federal regulation of a field of commerce will be deemed preemptive of state regulatory power.[80]

As stated earlier, Congress felt foreign commerce would be encouraged by exempting goods stored in a zone from custom

75. 271 Cal.2d 437, 77 Cal. Rptr. 570 (1969), *cert. denied*, 396 U.S. 273 (1970).

76. 77 Cal. Rptr. at 592-97.

77. *Id.* at 599.

78. *Id.* Bonded warehouses are authorized by 19 U.S.C. § 1555 (1976).

79. 77 Cal. Rep. at 596. This issue of state taxation of goods in a foreign-trade zone is now being litigated in California. *See* Lilli-Ann Corp. v. City & County of San Francisco, No. 726-271 (Super. Ct. of San Francisco County filed July 29, 1977).

80. Florida Lime and Avocado Growers, Inc. v. Paul, 373 U.S. 132 (1963).

duties.[81] Congress, in passing the Foreign-Trade Zones Act, made no distinction between goods destined for the United States and those destined for other countries. Congress could have done so. The fact that Congress did not could arguably mean that it felt foreign commerce would be fostered by the use of a foreign-trade zone regardless of the destination of the goods in the zone. If states are permitted to levy taxes on items in a zone, many of the cost benefits foreign-trade zones offer to exporters and importers will be decreased.

In addition, foreign commerce will be encouraged if state taxes are not permitted to be levied on goods in a foreign-trade zone, even if those goods are destined for United States customs territory. Potential importers and exporters of goods will have a further inducement to engage in foreign commerce if they know a place exists where goods can be stored or processed without the imposition of duties or taxes. Since state taxes would increase a zone user's costs, even where the goods never enter U.S. customs territory, they too discourage foreign commerce, thus conflicting with the congressional mandate demonstrated by the Foreign-Trade Zones Act.[82] Such taxes thwart the primary purpose of a foreign-trade zone.

Also, state taxation of the zones interferes with the desire Congress had to simplify matters when it passed the Foreign-Trade Zones Act, bonded warehouses and drawbacks frequently being more complex solutions.[83] State taxation introduces a complicating element, particularly since some states will have the tax and others will not, presenting the anomaly that foreign-trade zones will be more beneficial to exporters and importers in some areas than others. "Persuasive reasons" thus exist for exempting foreign-trade zones from state taxation.

Federal Taxation

Apart from customs duties, foreign-trade zones are not exempt from federal taxation. The Foreign-Trade Zones Act makes no mention of exempting goods in a zone from anything other than customs duties. The sponsor of the Act, Congressman Emmanuel Celler stated: "[Foreign-trade zones are] . . .

81. *See* Purpose Clause, note 69 *supra*.
82. *Id. See also* related discussion.
83. *See* introductory discussion *supra*.

subject to all the laws relating to . . . everything except the customs."[84] Additionally, the Internal Revenue Service is of the opinion that federal income taxes do apply to income derived from foreign-trade zones, although goals are exempt from the manufacturer's excise tax.[85]

Some would argue[86] that since nonexempted federal revenue laws apply to zones, state laws should similarly apply. A possible fallacy in this line of reasoning is that the federal authority over foreign commerce is plenary. The federal government can reshape its policies as expressed by the Foreign-Trade Zones Act.[87] The Federal Constitution does not give the states such powers.

IV. STATE LEGISLATION

One facet of the study of foreign-trade zones which has received scant attention from commentators is that of state legislation engendered by the Foreign-Trade Zones Act.[88] This section proposes, first,. to ascertain the necessity (if any) for such legislation under the Act and, second, to discuss ways in which such state enactments, whether required or not by the Act, can contribute to the efficient establishment, operation, and maintenance of foreign-trade zones.

Statements may be found in the literature of foreign-trade zones suggesting that enabling or authorizing legislation enacted by the state in which the zone is to be located is a prerequisite to any application for or grant of the privilege to establish, operate, and maintain such a zone.[89] If such statements are construed to mean that the Act requires state enabling legislation prior to *any* application or grant, they may not be wholly accurate. Close scrutiny of the provisions of the Act indicates that, under certain circumstances, application for a

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84. 78 CONG. REC. 9853 (1934).

85. Rev. Rul. 76-161, 1976-1 C.B. 193; Rev. Rul. 59-318, 1959-2 C.B. 310.

86. *See* Letter from Legislative Council of California to Senator Alquist (February 4, 1976).

87. *See* California v. Zook, 336 U.S. 725 (1949).

88. 19 U.S.C. §§ 81a-u (1976).

89. "Before either a public or private corporation may apply to the Foreign-Trade Zones Board for operating authority, however, the state in which the zone is to be established must pass authorizing legislation." Davison, *Foreign-Trade Zones—An Aid to Those Doing Business Abroad*, 17 BUS. LAW. 960, 965 (1962). "An application for a zone may be made by either a public or private corporation, but only after an enabling statute has been enacted by the state where the zone is to be located." Note, *Foreign-Trade Zone Manufacturing: The Emergence of a Free Trade Instrument*, 9 VA. J. INT'L L. 444, 450 (1969) (footnotes omitted).

grant by a "public corporation," as therein defined,[90] need not be preceded by an authorizing enactment of the state in which the zone is to be established.

Applicants

A brief discussion of the nature of eligible applicants may be useful in determining when state enabling legislation is or is not a prerequisite to application. According to the terms of the Act, an "applicant"[91] for (and "grantee"[92] of) the privilege of establishing, operating, and maintaining a zone must be a "corporation,"[93] as therein defined. A "corporation," in turn, may be either a "public corporation"[94] or a "private corporation."[95] The definition of a "public corporation" encompasses a rather extensive hierarchy of governmental entities: "The term 'public corporation' means a State, political subdivision thereof, a municipality, a public agency of a State, political subdivision thereof, or municipality, or a corporate municipal instrumentality of one or more States."[96] A "private corporation," on the other hand, is defined as: "[A]ny corporation (other than a public corporation) which is organized for the purpose of establishing, operating, and maintaining a foreign-trade zone and which is chartered under special Act enacted after June 18, 1934, of the State or States within which it is to operate such zone."[97]

Private Corporations and the Special Act

Limitation of the definition of a "private corporation" to one which "is chartered under special Act . . . of the State or States within which it is to operate such zone" quite obviously envisions the existence of such "special Act" and has the effect of making such "special Act" a prerequisite under the Foreign-Trade Zones Act to application by (and grant to) a "private corporation." Regulations promulgated by the Foreign-Trade Zones Board are not entirely unambiguous on this point, but do appear to confirm the interpretation that an authorizing enactment of the State is necessary prior to a grant of the

90. 19 U.S.C. § 81a(e) (1976); *see also* 15 C.F.R. § 400.105(a) (1977).
91. 19 U.S.C. § 81a(g) (1976); *see also* 15 C.F.R. § 400.106 (1977).
92. 19 U.S.C. § 81a(h) (1976); *see also* 15 C.F.R. § 400.107 (1977).
93. 19 U.S.C. § 81a(d) (1976); *see also* 15 C.F.R. § 400.105 (1977).
94. 19 U.S.C. § 81a(e) (1976); *see also* 15 C.F.R. § 400.105(a) (1977).
95. 19 U.S.C. § 81a(f) (1976); *see also* 15 C.F.R. § 400.105(b) (1977).
96. 19 U.S.C. § 81a(e) (1976); *see also* 15 C.F.R. § 400.105(a) (1977).
97. 19 U.S.C. § 81a(f) (1976); *see also* 15 C.F.R. § 400.105(b) (1977).

privilege to a "private corporation": "Grants to private corporations will not be approved by the Board unless such corporations have been authorized by an act of the State legislature (enacted after June 18, 1934)."[98]

Additional support, if any were needed, for the proposition that state enabling legislation constitutes a precondition to application for (and grant of) the privilege to a "private corporation" may be garnered from the legislative history of House Bill H.R. 9322, which (with certain amendments not here pertinent) subsequently became the Foreign-Trade Zones Act.[99]

The term "special Act" is not further defined in either the Act or the regulations[100] of the Foreign-Trade Zones Board promulgated thereunder. It is not surprising, therefore, that the individual states, left to their own devices, have formulated a variety of legislative responses to the "special Act" requirement. These range from blanket authorization[101] by the state of any "private corporation" wishing to apply for the privilege, to the pointed omission[102] of any reference to "private corporations" from state legislation pertaining to foreign-trade zones. Less extreme positions are represented by state statutes such as those which authorize applications by any "private corporation" organized under the laws of the enacting state for the purposes of establishing, operating, and maintaining a foreign-trade zone in accordance with the Act,[103] or by any non-public "not-for-profit corporation authorized to do business" in the

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98. 15 C.F.R. § 400.502 (1977).

99. "It is to be noted that the only private corporations which are eligible for the operation of foreign-trade zones are ones specially chartered by the State or States in which the zone is to be established." H.R. REP. No. 1521, 73d Cong., 2d Sess. 4 (1934). "The House bill limited the organizations (other than public corporations) which might operate zones to corporations chartered under special act enacted after the date of this act of the State or States within which the zone was to be operated. The Senate amendment broadens the class of operators to include partnerships and associations and removes the requirement with respect to special charter in the case of corporations. The Senate amendment also includes organizations existing under or authorized by the laws of the United States. The conference agreement adopts the House provision." H.R. REP. No. 1884, 73d Cong., 2d Sess. 2 (1934). "Private corporations are authorized to establish such zones only in the case such zones are not established by the States or other public agencies, with a further limitation that they must be chartered by the State legislature." 78 CONG. REC. 9768 (1934) (remarks of Rep. Cullen).

100. 15 C.F.R. §§ 400.100-.1406 (1977).

101. *See, e.g.*, ALA. CODE § 33-1-30 (Supp. 1977).

102. *See, e.g.*, HAWAII REV. STAT. §§ 212-1 to -10.

103. *See, e.g.*, CAL. GOV'T CODE § 6306 (West).

state,[104] or by a "private corporation" identified by name.[105]

It is important to note, before turning to a consideration of public corporations, that the Act mandates that preference be given to the application of a "public corporation" over that of a "private corporation": "In granting applications preference shall be given to public corporations."[106] The strength of this preference may be gauged by the historical fact that, as of the time of this writing, few private corporations have received a grant of the privilege of foreign-trade zone establishment, operation, and maintenance.[107] Thus, even assuming the prior enactment of appropriate legislation by the state in which the zone would be located, application by a "private corporation" could prove unsuccessful.

Public Corporations

Although mention of any "special Act"[108] is conspicuously absent from the definition of the term "public corporation,"[109] it is not to be presumed that state legislation is not a prerequisite to application by or grant to a public corporation in every case. As to those states in which the circumstances described in section 81b(d) of the Act exist, "an Act of the legislature of such State" is required prior to grant of the privilege:

> In case of any State in which harbor facilities of any port of entry are owned and controlled by the State and in which State harbor facilities of any other port of entry are owned and controlled by a municipality, the Board shall not grant an application by any public corporation for the establishment of any zone in such State, unless such application has been authorized by an Act of the legislature of such State (enacted after June 18, 1934.)[110]

This provision was evidently intended to deny to states wishing to apply for a grant an advantage not possessed by municipalities which were similarly inclined. While a state could make application for a zone in its port of entry at once, a municipality might be obliged to make a time-consuming approach to the state legislature for authority to issue bonds to

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104. KAN. STAT. § 12-825h.

105. TEX. REV. CIV. STAT. ANN. art. 1446.7 (Vernon).

106. 19 U.S.C. § 81b(c) (1976); 15 C.F.R. § 400.503 (1977).

107. Telephone conversation with John J. Da Ponte, Jr., Executive Secretary, Foreign-Trade Zones Board (November 16, 1978).

108. 19 U.S.C. § 81a(f) (1976); 15 C.F.R. § 400.105(b) (1977).

109. 19 U.S.C. § 81b(e) (1976); 15 C.F.R. § 400.105(a) (1977).

110. 19 U.S.C. § 81b(d) (1976); 19 C.F.R. 400.501 (1977).

raise funds needed for establishing a zone in its port of entry.[111]

Except as provided in section 81b(d), the Act does not require that the application of a "public corporation" have been previously authorized by an act of the legislative body of the state in which the zone is to be located. It may be concluded, therefore, that, for the purposes of the Foreign-Trade Zones Act, the necessity of prior state legislative authorization of an application by a "public corporation" is determined by the applicability of the provisions of section 81b(d) to the state in question. In other words, a state to which section 81b(d) applies, by virtue of the existence within such state of the circumstances set out in that section, must give prior legislative authorization to an application by any of its "public corporations." Conversely, a state to which section 81b(d) is inapplicable, for whatever reason, is *not* obliged by the Act to give prior legislative authorization to any application by any of its "public corporations."

That section 81b(d) does not apply to all states seems plain. By its terms, its applicability to a given state is dependent upon the existence of at least two United States Customs ports of entry within the state. Hence, it cannot apply to a state in which there is only one such port of entry.[112] The state of

111. The committee had in mind that in some States there are ports in which the State owns the water front or where the city owns it; and the committee was confronted with the situation where the State could immediately establish a foreign trade zone in its State-owned port, whereas the city-owned port would have to go to the legislature for authority to issue bonds to raise the necessary money to establish the foreign-trade zone. The committee felt that it was not fair to give this advantage to the State; that both should start on a par; that both should have the same opportunity.

78 CONG. REC. 9976 (1934) (remarks of Mr. McCormack).

112. Mr. McDUFFIE. I think the committee has been eminently fair in meeting the situation; but I refer to the case of a port in which not only does the State own facilities but the municipality also owns facilities.

I think New Orleans, La., occupies this position and I know the port of Mobile, in my district, in Alabama, is in a similar position. I was fearful there might be some delay in those cities taking advantage of this legislation which I heartily approved.

Mr. VINSON of Kentucky. If I understand the gentlemen from Alabama, the case which he presents is where both State and cities own harbor facilities, of course, at the same place.

Mr. McDUFFIE. At the same place.

Mr. VINSON of Kentucky. It is my understanding that in that character of case subsection (d) would not apply.

Mr. McCORMACK. That is my opinion.

Mr. McDUFFIE. *Subsection (d) is made to apply to 2 ports and 2 cities in the same State.*

Colorado, for example, within its single United States Customs port of entry at Denver,[113] would seem not to come within the scope of section 81b(d). Consequently, the Foreign-Trade Zones Act does not appear to require that the application of a Colorado "public corporation" have been previously authorized by an Act of the State's legislature.

Although worded somewhat differently[114] than section 81b(d) of the Act, section 400.501 of the regulations of the Foreign-Trade Zones Board seems to be identical in effect and is thus susceptible to the same analysis as is section 81b(d). However, section 400.603(k)[115] of the regulations, which deals with an exhibit that must accompany an application for grant, may create some confusion in determining whether the application of a public corporation must have been authorized by the state legislature. This section, in pertinent part, states:

> (1) If the applicant is a State, the application for a grant shall be accompanied, as evidence of the applicant's qualifications to make application, by a copy of the law or laws under authority of which the application is made, duly certified by the Governor or secretary of state of the State under seal, and three uncertified copies of such law or laws (enacted after June 18, 1934).
>
> (2) If the applicant is a public corporation, other than a State, as defined in section 1(e) of the Act, the application for a grant shall be accompanied by evidence of the applicant's qualifications to make the application as follows:
>
> (i) A copy of its charter or other organization papers duly certified by the secretary of state of the State in which it is located, or by the officer having legal custody of the record of municipal and other public corporations (one copy only);
>
> (ii) A statement under seal of the secretary of state of the State or other officer charged by State laws with supervision of harbor facilities, setting forth whether the State owns and controls harbor facilities of any port of entry and whether harbor facilities of any other port of entry in the State are owned and

Mr. VINSON of Kentucky. *Yes.*"

78 CONG. REC. 9776 (1934) (remarks of Messrs. McDuffie, Vinson and McCormack) (emphasis added).

113. 19 U.S.C. § 2 (1976); *see also* 19 C.F.R. § 1.2 (1977).

114. Where harbor facilities of any port of entry in the State are owned and controlled by the State, and where habor facilities of any other port of entry in the State are owned and controlled by a municipality, grants to public corporations will not be approved by the Board unless such applications have been authorized by an act of the State legislature enacted after June 18, 1934.

15 C.F.R. § 400.501 (1977).

115. 15 C.F.R. § 400.603(k) (1977).

controlled by a municipality with three uncertified copies of such statement."[116]

The language in subsection (1) of section 400.603(k) referring to "the law or laws under authority of which the application is made . . . (enacted after June 18, 1934)" could conceivably be interpreted to impliedly require *in every case* authorizing state legislation prior to application by a state itself—an interpretation which appears at odds with the Act in general and section 81b(d) in particular. Moreover, subsection (2) of section 400.603(k), which applies to "a public corporation other than a state" (a distinction not made in the Act) does not refer to state legislation authorizing application for grant, despite the fact that such legislation would presumably have been a prerequisite to such application if the circumstances within the state rendered section 81b(d) applicable. In short, section 400.603(k)(1) can be read as requiring as an exhibit to any application by a state a copy of a law whose existence *is not* mandated by the Act, while section 400.603(k)(2) can be read as *not* requiring as an exhibit to any application by a "public corporation other than a state" a copy of a law or laws whose existence *is*, under certain conditions, expressly mandated by section 81b(d) of the Act.

The present Executive Secretary of the Foreign-Trade Zones Board has informally indicated that, while as a general matter applications are most often authorized by a state enactment, section 400.603(k)(1) is not to be regarded as an indirect requirement of state authorizing legislation in cases where such legislation is not otherwise mandatory under the Act. With respect to a state which believes itself to be outside the applicability of section 81b(d), an option may exist in the case of an application by a "public corporation." The state may enact authorizing legislation which, though not technically required under the Act, could prove useful in other ways. Alternatively, a "public corporation" could meet the requirements of section 400.603(k) by including as Exhibit 11 to its application (a) an opinion of the state's attorney general (or other official performing the function of legal counsel and advisor to the state) setting out the grounds upon which the provisions of section 81b(d) of the Act are deemed to be inapplicable to the state and (b) documentation such as state constitutional or statutory provisions or organizational charters which set out the legal

116. 15 C.F.R. § 400.603(k)(1)-(2) (1977).

basis for the establishment and existence of the particular "public corporation" applicant.[117]

Contributions of State Legislation

As indicated in the preceding discussion, one function of state legislation is compliance with the Foreign-Trade Zones Act in those cases in which an application for grant must have received prior authorization of the state legislature. State legislation may, however, serve a somewhat broader, more positive purpose in contributing to the efficient establishment, operation, and maintenance of foreign-trade zones. Even in those states in which an application by a public corporation need not be legislatively authorized, state legislation may be a means of clarifying a state's position with respect to zones within its borders, as well as a way of obviating difficulties which have plagued zones in other jurisdictions.

The discussion which follows identifies a limited number of the potentially great range of issues relating to foreign-trade zones which may be susceptible to resolution through state legislation; additionally, certain examples drawn from existing state statutes serve to illustrate some of the ways in which these "foreign-trade zone-related" issues have been addressed legislatively by the individual states.

A threshold issue in the establishment of a zone in any state relates to the designation of applicants for grant of the privilege. Designation of appropriate applicants is, of course, an integral part of legislation authorizing an application when such is required under the Act.[118] However, where such prior authorization is not mandatory under the Act, a state enactment setting out those organizations deemed to be appropriate applicants may nevertheless clarify a potentially murky aspect of foreign-trade zone establishment.

State statutory designations of appropriate "public corporation" applicants range from those which are nearly as broad as the definition of a "public corporation"[119] under the Act to those which are as narrow as the meaning of a single specific governmental entity. A definitional provision of the California statute exemplifies the former category: " '[P]ublic corporation' means the State, any political subdivision thereof, any incorporated municipality therein, any public agency of the State, or any political subdivision thereof, or of any municipal-

117. Telephone conversation with John J. Da Ponte, Jr., Executive Secretary, Foreign-Trade Zones Board (September 22, 1978).

118. *See* notes 91-107 *supra* and accompanying text.

119. 19 U.S.C. § 81a(e) (1976).

ity therein, or any corporate municipal instrumentality of this State or of this State and one or more States."[120] Typical of the latter category is the Illinois foreign-trade zone statute, which states in part: "*The Port District* has power to apply to proper authorities of the United States of America pursuant to appropriate law for the right to establish, operate, maintain, and lease foreign-trade zones."[121] (Emphasis added.) In some instances, state statutes have combined relatively broad designations of applicants of the "public corporation" type with somewhat more specific references or criteria intended, presumably, to facilitate a determination of which governmental entities come within the sweep of the more general language. The Florida statute concludes its definition of the term "governmental agency"—the functional equivalent of "public corporation" under the Foreign-Trade Zones Act—with the statement that: "Specifically included [in the definition] are airports, port authorities, and industrial authorities."[122] An alternative approach to specific reference appears in the Michigan statute which employs the presence or absence of public funds in the financing of the organization in question as the criterion for determining which governmental entities may apply for a grant: " 'Public corporation' means the state, or any county, township, city or village within the state, or any state or municipal authority or similar organization *financed in whole or in part by public funds*."[123] (Emphasis added.)

With respect to "private corporations," state statutes, as mentioned previously,[124] have run a gamut from omitting reference to such corporations altogether to embracing any such corporation as an applicant. In view of the preference for grants to public corporations expressed by the Act[125] and substantiated by historical fact, the omission of the designation of private corporations as appropriate applicants—an approach taken in Hawaii's statute[126]—may be quite realistic.

However, if the state elects to designate what it considers to be suitable applicants of the "private corporation" type,

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120. CAL. GOV'T CODE § 6300 (West).
121. ILL. ANN. STAT. ch. 19, § 159.1 (Smith-Hurd).
122. FLA. STAT. ANN. § 288.35(2) (West).
123. MICH. COMP. LAWS ANN. § 447.1(b).
124. *See* notes 101-105 *supra* and accompanying text.
125. 19 U.S.C. § 81b(c).
126. HAWAII REV. STAT. §§ 212-2 to -3.

some legislative formulae seem more serviceable than others. To illustrate, the Alabama statute authorizes "*any . . . private corporation* . . . to establish at all ports of entry within this state foreign trade zones."[127] (Emphasis added.) Conceivably, this provision could be construed to authorize any private corporation, whether or not incorporated or otherwise qualified to do business in Alabama, to apply for and receive a grant. The possibility of an unqualified foreign corporation establishing, operating, and maintaining a foreign-trade zone within the state may be an undesirable contingency from the state's perspective. On the other hand, a provision such as that in the Texas statutes designating, along with certain other "public corporations," a single "private corporation incorporated under the laws of the state"[128] may be susceptible to challenge as unfair to another private corporation which might be desirous of establishing a foreign-trade zone. A legislative formula which avoids the foregoing criticisms may be found in the Georgia statute:

> Any private corporation hereafter organized under the laws of this state for the purpose of establishing, operating and maintaining a foreign-trade zone in accordance with [the Foreign-Trade Zones Act] is likewise hereby authorized to make application for the privilege of establishing, operating and maintaining a foreign-trade zone in accordance with the said [Foreign-Trade Zones Act].[129]

State legislation may also prove useful in propounding state policy with respect to operation of an established foreign-trade zone by a "private corporation" which is not the grantee. It is likely, for reasons discussed previously,[130] that recipients of future grants of the privilege will be "public corporations." Such a grantee would be, by definition, a governmental entity and, if it were to operate and maintain the zone itself, would presumably expend public funds and employ public servants for that purpose. Conceivably this arrangement could bring about unsatisfactory consequences, as, for example, competition between a foreign-trade zone and a school system (or other public institutions) for monies and personnel. To reduce the possibility of such costly and inefficient rivalries, the state

127. *See* note 101 *supra*.
128. *See* note 105 *supra*.
129. GA. CODE ANN. § 98-303.
130. *See* notes 106-107 *supra* and accompanying text.

could by statute expressly countenance contractual relations between the "public corporation" grantee and a "private corporation" whereby the latter, at its own expense, would undertake to operate and maintain the zone as a public utility[131] on behalf of the grantee. Neither the Act nor the regulations of the Foreign-Trade Zones Board addresses the propriety of this arrangement directly. While a "grant shall not be sold, conveyed, transferred, set over, or assigned,"[132] there is an acknowledgment in the early case of *American Dry Dock v. City of New York* to the effect that the Foreign-Trade Zones Board does not consider a contract between a "public corporation" grantee and a "private corporation" for operation of a zone violative of this prohibition.[133] Moreover, a review of the most recent annual report of the Foreign-Trade Zones Board reveals several instances in which such contractual arrangements for zone operation exist.[134]

The statutes of the state of Washington contain an example of one technique which may be used to give express legislative approval to zone operation by nongrantee "private corporations":

> A city or town, as zone sponsor, may apply to the United States for permission to establish, operate, and maintain foreign trade zones: *Provided*, that nothing herein shall be construed to prevent these zones from being operated and financed by a private corporation(s) on behalf of a city or town acting as zone sponsor.[135]

Questions regarding zone location may also be an appropriate object of state legislation. As discussed in a previous section, the Foreign-Trade Zones Act requires in effect that zones shall be "in or adjacent to ports of entry" but does not define the term "adjacent."[136] Not surprisingly, therefore, state legislative responses to the "in or adjacent" language vary from general references to ports of entry within the state to rather precise descriptions of the area in which a zone may be established. More precision rather than less in setting forth appro-

131. 19 U.S.C. § 81(n) (1976).

132. 19 U.S.C. § 81(g) (1976).

133. American Dock Co. v. City of New York, 21 N.Y.S.2d 943, 949, 174 Misc. 813 (1940), *aff'd* 26 N.Y.S.2d 704, 261 App. Div. 1063, *aff'd* 36 N.E.2d 696, 286 N.Y. 658.

134. FOREIGN-TRADE ZONES BOARD, 38TH ANNUAL REPORT (1976).

135. REV. CODE WASH. ANN. § 35.21.805 (1977 Supp.); *See also* §§ 24.46.020, 36.01.125.

136. *See* notes 34-42 *supra* and accompanying text.

priate areas for zone establishment may be desirable, since a very broad description (or no description at all) of such an area may give rise to unrealistic expectations of zone establishment nearby, based upon the mistaken notion that there are few or no restrictions on zone location. By way of illustration, the Illinois statute requires that any zone be "within the limits of the Chicago Regional Port District."[137]

A related consideration which may be addressed by state legislation is that of *who* may select specific zone sites within the designated areas. One logical choice is, of course, the applicant for grant of the privilege, and certain states have, in fact, enabled applicants to select and describe zone sites: "Any corporation or government agency may select and describe the location of the foreign-trade zones or foreign-trade subzones for which an application is made."[138]

Perhaps the most substantial contribution state legislation may make to efficient establishment and operation of foreign-trade zones is the clarification of state and local taxing policies with respect to zones. The California statute, for example, makes no reference to state and local taxes as they may apply to foreign-trade zones within the state.[139] The fact that litigation of this issue is underway in California at the time of this writing may serve to underscore the seriousness of the statutory omission.[140]

In a few instances, states have dealt with the question of state and local taxes in legislation pertaining to foreign-trade zones. Hawaii provides an exemption from certain taxes for sales of specified products in a zone to specified purchasers.[141] Massachusetts spells out the incidence of real property taxes upon land within a foreign-trade zone.[142] Oregon exempts personal property "in transit" through the state from certain state taxes.[143] These measures do not, however, seem to represent as complete a treatment of the state and local taxation issues as may be desirable in light of the possibility of litigation.

137. *See* note 121 *supra*.

138. FLA. STAT. ANN. § 288.37 (West).

139. CAL. GOV'T CODE § 6300-6305 (West).

140. Lilli-Ann Corp. v. City & County of San Francisco, No. 726-271 (Super. Ct. of San Francisco County, filed July 29, 1977).

141. HAWAII REV. STAT. § 212-8.

142. MASS. GEN. LAWS ANN. ch. 91 App. § 1-3(g) (1978 Supp.)

143. OR. REV. STAT. § 307.810.

IV. CONCLUSION

The principal purpose of the Foreign-Trade Zones Act is to expedite and encourage foreign commerce. Whether this purpose will be fulfilled in a particular case is in some measure determined by the availability of sub-zones, by state and local taxing policies with respect to zones, and by state legislation relating to zones. As the foregoing discussion has sought to demonstrate each of these matters has a potentially significant impact upon the establishment and operation of any foreign-trade zone.

STUDENT COMMENT

The I.R.S. and the Foreign Tax Credit: The Restrictive View of Revenue Ruling 78-61.

James J. Dufficy*

I. Introduction

In 1978 the Internal Revenue Service issued two rulings[1] that clarify its position with respect to the creditability of foreign income, war profits, or excess profits taxes.[2] This comment will examine the position taken by the I.R.S. in one of those rulings.[3]

In Rev. Rul. 78-61, the Ontario Mining tax was held to be neither an income tax nor a tax in lieu of an income tax within the meaning of sections 901 and 903 of the Internal Revenue Code, and the credit for the tax was denied.[4]

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1. Rev. Rul. 78-61, I.R. Bull. No. 1978-8 11; Rev. Rul. 78-62, I.R. Bull. No. 1978-8 16.

2. The foreign tax credit provision is contained in I.R.C. § 901. Pertinent provisions include:

> (a) Allowance of Credit - If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the applicable limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) . . .
>
> (b) Amount Allowed - Subject to the limitation of section 904, the following amounts shall be allowed as the credit under subsection (a):
>
> (1) Citizens and domestic corporations - In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; . . . .

3. While dealing *directly only* with Rev. Rul. 78-61, this comment will, *in effect*, deal also with Rev. Rul. 78-62, since the latter revolves around the same principles of creditability as the former.

4. I.R.C. § 903 grants an alternative credit for any taxes paid to a foreign country in lieu of an income tax. Under Treas. Reg. 1.903-1(a)(3), 1957-2 C.B. 419, the credit can be claimed only: (a) if the country has in force a general income tax law; (b) if the taxpayer would be subject to the tax in the absence of a specific exemption; and (c) if the income tax is not imposed upon the taxpayer subject to the substitute tax.

In the instance case the I.R.S., after denying the § 901 credit, also properly denied a credit under § 903 because the taxpayer in question was also subject to a general income tax from which he had not been exempted by the operation of the mining tax. This part of the decision will not be considered further, as it was amply justified in light of relevant case authority. On the creditability of "in lieu of" taxes, *see generally* Northwestern Mut. Fire Ass'n v. Commissioner, 181 F.2d 133 (9th Cir. 1950); Abbot Laboratories Int'l Co. v. United States, 160 F. Supp. 321 (N.D. Ill. 1958), *aff'd per*

The tax was levied on all profit of any mine in the Canadian province of Ontario if the profit from the mining function exceeded $50,000 for the taxable year. "Profit" under the act was defined as the sum of the gross receipts from the sale of ore, plus the actual market value of unsold ore that had been extracted during the year, less a narrow group of deductions.

The I.R.S. disallowed the credit under these circumstances. The mining tax was held to be levied not on income actually received from extracting and selling the ore, but on the value of the extraction. The tax was due on the value of the output whether or not it was sold (and in the case of output that had been incorporated into the owner's manufacturing process, in spite of the fact that it never would be sold). Furthermore, the Ontario tax did not allow the deduction of significant operating expenses that are deductible under the Internal Revenue Code of the United States. Some of the more important nondeductible expenses were interest, initial exploration and development expenses, taxes and royalties paid, depletion allowances, salaries and other expenses not directly connected to the mining function (in a typical mining enterprise, there are also manufacturing and treatment functions). Since this tax was levied on the market value of the extracted ore and not on an actual income base, the I.R.S. classified it as "a production or severance tax on the mining privilege," a noncreditable tax.[5]

II. BACKGROUND

The United States Government taxes its nationals on their worldwide income. This method of taxation could lead to double taxation, *i.e.*, paying income taxes on the same income to the United States and to the country where the income

curiam, 267 F.2d 940 (7th Cir. 1959); Compania Embotelladora Coca-Cola v. United States, 139 F. Supp. 953 (Ct. Cl. 1956); F.W. Woolworth Co. v. Commissioner, 54 T.C. 1233 (1970), *nonacq. on another issue*, 1971-2 C.B. 4.

5. The I.R.S. also properly ruled that this tax should be considered in its entirety, as it is an indivisible tax. As a general rule, when a tax is imposed upon more than one base, one of which would qualify as a proper base for the credit and one or more of which would not, that part of the tax levied upon a qualifying base will be creditable provided it is computed separately from the tax that is imposed upon a nonqualifying base. In the instant case, all of the various bases (output sold, output incorporated in a manufacturing process, and output sold after treatment) were combined, the allowable deductions were expensed against the entire base, and the tax was then computed upon the single base. *Cf.* Lanman & Kemp-Barclay & Co. of Columbia v. Commissioner, 26 T.C. (1956); Rev. Rul. 74-435, 1974-2 C.B. 204.

has been earned.[6] To prevent double taxation, Congress granted a tax credit.[7] Generally, section 901 allows a credit (a dollar-for-dollar reduction from overall tax liability)[8] for any income, war profits, or excess profits taxes paid to a foreign country.[9] The major source of contention within section 901 has been over the meaning of the words "income tax"; that is, when is a particular foreign tax an income tax within the meaning of section 901?

For nearly twenty years after the original enactment of the foreign tax credit provision in 1918, the Supreme Court allowed the foreign characterization of the tax as an income tax to control creditability.[10] However, with the landmark case of *Biddle v. Commissioner,*[11] the courts now refuse to allow a foreign characterization of a tax to control. Since *Biddle,* the courts have consistently applied the American conception of "income tax":[12] the foreign tax must be the substantial equiva-

6. For a general discussion of the problems of double taxation, *see generally* H.R. REP. No. 94-658, 94th Cong., 1st Sess. (1975), 1976-3 C.B. 695, 904; *Characterization of an Income Tax for the Purpose of the Foreign Tax Credit,* 14 VAND. L. REV. 1469 (1961).

7. "The primary objective . . . [of § 901] is to prevent double taxation and a secondary objective is to encourage American foreign trade." American Metal Co. v. Commissioner, 221 F.2d 134, 137 (2d Cir. 1955).

8. I.R.C. § 164(a) allows a deduction of such taxes even if the credit is denied. This is generally less favorable to the taxpayer because the deduction merely reduces the tax base upon which U.S. income tax is levied, while a credit directly reduces the amount of the tax liability by the amount of the credit.

9. Taxes which are paid to a political subdivision of a foreign country are also creditable if they qualify. *See* Burnet v. Chicago Portrait Co., 285 U.S. 1 (1931); Havana Electric Railway, Light & Power Co. v. Commissioner, 34 B.T.A. 782 (1936) (an income tax imposed by the municipality of Havana was creditable under § 901).

10. Eitington Schild Co. & Subsidiaries v. Commissioner, 21 B.T.A. 1163 (1931) (a turnover tax imposed upon all business activity in France was not a qualifying income tax for purposes of the foreign tax credit, largely because France had imposed this tax apart from its income tax).

11. 302 U.S. 573 (1938).

12. *See* New York & Honduras Rosario Mining Co. v. Commissioner, 168 F.2d 745 (2d Cir. 1948) (Houduran tax imposed upon liquid profits derived from the mining enterprise was credited because of its similarity to the United States income tax); Keasbey & Mattison Co. v. Rothensies, 133 F.2d 894 (3rd Cir. 1943), *cert. denied,* 320 U.S. 739 (1943) (Quebec mining tax was noncreditable because the tax base, the value of ore extracted, did not constitute an income base in the United States sense); *accord,* Motland v. United States, 192 F. Supp. 358 (N.D. Iowa 1961); St. Paul Fire & Marine Ins. Co. v. Reynolds, 44 F. Supp. 863 (D. Minn. 1942); Bank of America Nat'l Trust & Sav. Ass'n v. United States, 459 F.2d 513 (Ct. Cl. 1972), *cert. denied,* 409 U.S. 949 (1972); F.W. Woolworth Co. v. Commissioner, 54 T.C. 1233 (1970), *nonacq. on another issue,* 1971-2, C.B. 4; Lanman & Kemp-Barclay & Co. of Colombia v. Commissioner, 26 T.C. 582 (1956).

lent of an income tax as defined by United States law.[13] The scant legislative history on the issue of creditability gives implicit approval to this test.[14]

To determine whether a particular tax is the substantial equivalent of the United States income tax, the courts look primarily to the tax base. To qualify for a credit, the foreign tax must be levied on a base that corresponds closely to income as understood in the United States. This conclusion indicates that the tax must be imposed on either a gain realized or a profit derived from capital, labor, or both,[15] since this is the traditional United States definition of income.[16]

In Rev. Rul. 78-61, the I.R.S. established three requirements that a foreign tax must meet to qualify as a creditable income tax on a proper tax base:[17]

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13. *See* Seatrain Lines, Inc. v. Commissioner, 46 B.T.A. 1076 (1942) (Cuban tax levied upon gross income was credited); Santa Eulalia Mining Co. v. Commissioner, 2 T.C. 241 (1943), *appeal dismissed*, 142 F.2d 450 (9th Cir. 1944) (Mexican tax upon gross royalties received was credited because the significant expenses incurred in producing the income were already deducted by the party paying the royalty).

14. *See* S. REP. No. 1631, 77th Cong., 2d Sess. (1942), 1942-2 C.B. 602. This report concerned the initial enactment of § 903, the "in lieu of" credit, which was considered necessary by the committee because of the narrow reading given § 901 by the courts and the I.R.S.

> In the interpretation of the term "income tax," the Commissioner, the Board [B.T.A.], and the courts have consistently adhered to a concept of income tax rather closely related to our own, and if such foreign tax was not imposed upon a basis corresponding approximately to net income it was not recognized as a basis for such credit. . . . Your committee has deemed it desirable to extend the scope of this section.

The fact that the extension of the credit provision took the form of the "in lieu of" provision rather than an actual enlargement of § 901, gives implicit approval to the narrow construction of this section. *See* Motland v. United States, 192 F. Supp. 358 (N.D. Iowa 1961).

15. *E.g.*, Bank of America Trust & Sav. Ass'n v. United States, 459 F.2d 513 (Ct. Cl. 1972), *cert. denied*, 409 U.S. 949 (1972).

16. *Accord*, Keasbey & Mattison Co. v. Rothensies, 133 F.2d 894, 897 (3rd Cir. 1943), *cert. denied*, 320 U.S. 739 (1943); Abbot Laboratories Int'l Co. v. United States, 160 F. Supp. 321, 331 (N.D. Ill. 1958), *aff'd per curiam*, 267 F.2d 940 (7th Cir. 1959); Allstate Ins. Co. v. United States, 419 F.2d 409, 414 (Ct. Cl. 1969); Lanman & Kemp-Barclay & Co. of Columbia v. Commissioner, 26 T.C. 582, 587 (1956); Rev. Rul. 69-653, 1969-2 C.B. 152.

17. The I.R.S. held that it would determine whether the requirements were met by referring to the *entire class* of taxpayers subject to the foreign tax, rather than on a taxpayer-by-taxpayer or transaction-by-transaction basis. However, in Schering Corp. & Subsidiaries v. Commissioner, /1978/ Fed. Taxes (P-H) ¶ 69.46, at 57,471 (a decision issued contemporaneously with this Revenue Ruling), the I.R.S. attempted to persuade the Tax Court to make a determination of the noncreditability of a Swiss withholding tax by referring solely to the taxpayer, Schering Corp., while at the same

(1) The foreign tax must be levied on gain actually realized, since our own income tax is limited to realized as opposed to constructive gain. The I.R.S. requires a "substantially equivalent degree of realization with respect to foreign taxes."[18]

(2) The tax will be creditable only if "its purpose is to reach net gain and it is so structured so as to be almost certain of doing so." It is properly structured if, in the computation of the tax base, it is very unlikely that taxpayers will have to pay the tax if they have no net gain.[19]

(3) A credit is denied if the tax is not levied on the receipt of income but rather on "transactions such as sales or the exercise of a privilege or franchise." A tax that is imposed upon a transaction or a privilege is denied credit even if measured by net income.[20]

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time conceding that the tax in question was creditable when the entire class of taxpayers subject to the tax was considered. The court rejected this argument and granted the credit. This inconsistency on the part of the I.R.S. may be explained, at least in part, by the particular facts in the *Schering* case.

18. No authority directly supports this "three-pronged" test, but the I.R.S. does seem to be generally true to the judicial interpretation of § 901 in each of the criteria. The first prong (the tax must be levied upon gain actually realized) is clearly a proper application of § 901; *see* Motland v. United States, 192 F. Supp. 358 (N.D. Iowa 1961) (credit denied for a Cuban tax levied upon all capital exported from Cuba regardless of whether or not the capital represented actually realized gain); F.W. Woolworth Co. v. Commissioner, 54 T.C. 1233 (1970), *nonacq. on another issue*, 1971-2 C.B. 4 (credit denied for a British tax imposed upon the rental value of all property owned by the taxpayer, because this tax was imposed even if no rental income was realized from the property); Lanman & Kemp-Barclay & Co. of Colombia v. Commissioner, 26 T.C. 582 (1956) (credit denied for a Colombian patrimony tax imposed upon the appreciation of all property located in Colombia irrespective of actual realization by the taxpayer through sale); *accord*, Abbot Laboratories Int'l Co. v. United States, 160 F. Supp. 321 (N.D. Ill. 1958), *aff'd per curiam*, 267 F.2d 940 (7th Cir. 1959).

19. This second criterion (the tax must be designed to reach net gain), while generally true, seems somewhat restrictive considering Seatrain Lines, Inc. v. Commissioner, 46 B.T.A. 1076 (1942) (discussed *infra*). The I.R.S. seems to be attempting to restrict the credit to taxes that are structurally identical to our own in this test, an idea that runs counter to the *Seatrain* doctrine.

20. This third "test" (a privilege or excise tax is not creditable) actually seems to be little more than a conclusion to be drawn from the application of the first two tests. The courts uniformly deny a credit to taxes classified as "privilege" taxes, but the primary reasons for so classifying a tax are either because the tax is not imposed upon gain actually realized, or because the tax is not designed or intended to reach gain. Thus, while this "test" might be helpful in an overall consideration of a tax under § 901, it cannot truly stand independently. For decisions in this area, *see* Keasbey & Mattison Co. v. Rothensies, 133 F.2d 894 (3rd Cir. 1943), *cert. denied*, 320 U.S. 739 (1943) (discussed *infra*) (provincial Canadian tax imposed upon the value of extracted ore was classified as a privilege tax because the value of the extraction taxed included ore used by the operator, and thus represented gain never actually realized); American

When the above criteria are applied to the Ontario Mining severance tax, two principal issues emerge concerning the creditability of taxes that are imposed on only one facet of an operation:

(1) Must a taxpayer be granted all of the "normal" deductions before a tax will be considered an income tax?

(2) Can a tax be limited to income earned from a particular operation, *e.g.*, mining, and still qualify as an income tax?

III. ANALYSIS

A. *Must a taxpayer be granted all of the "normal" deductions before a tax will be considered an income tax for purposes of section 901?*

In the Ontario ruling, the mining severance tax was classified as a noncreditable privilege tax largely because the act disallowed the deduction of "significant operating expenses" that are deductible in the United States. The issue narrows to this: When are deductions that are not allowed by the foreign statute so significant as to deprive the tax of its characterization as an income tax?

The courts uniformly deny credit for any tax imposed upon gross receipts.[21] The area that is less clear is the amount between gross receipts and net income (as defined by United States law); this troublesome amount is gross income.[22]

While there are indications that some courts will categorically deny credit for a tax based on gross income,[23] the weight of authority is to the contrary. The leading case, *Seatrain*

Metal Co. v. Commissioner, 19 T.C. 879 (1953), *aff'd*, 221 F.2d 134 (2d Cir. 1955) (Mexican tax on mining output was classified as a privilege tax because it was levied upon the total value of output without any deductions, and was thus not aimed at gain or profit actually realized); Mallouck v. Commissioner, 34 B.T.A. 269 (1936) (Phillipine tax upon the value of exported goods was a noncreditable privilege tax both because it has no relation to gain realized through sale of the goods, and because nonpayment meant forfeiture of the privilege of doing business in the Phillipines).

21. *See* St. Paul Fire & Marine Ins. Co. v. Reynolds, 44 F. Supp. 863 (D. Minn. 1942); Allstate Ins. Co. v. United States, 419 F.2d 409 (Ct. Cl. 1969); Continental Ins. Co. v. Commissioner, 40 B.T.A. 540 (1939); I.T. 3429, 1940-2 C.B. 136.

22. Gross income may be defined as gross sales less the direct cost of making the sales. It is thus distinct from gross receipts which consist of all income including that which represents direct costs, while gross income excludes only the indirect costs of generating income (such as fixed and administrative expense). 1 MERTEN, LAW OF FEDERAL INCOME TAXATION § 5.10.

23. *E.g.*, St. Paul Fire & Marine Ins. Co. v. Reynolds, 44 F. Supp. 863 (D. Minn. 1942).

Lines, Inc. v. Commissioner,[24] indicates that under the proper circumstances a credit for a gross income tax will be allowed. *Seatrain* involved a Cuban tax on the gross income of shipping businesses. The tax was a flat 3% duty on gross income and was considered an income tax by Cuba. Furthermore, this 3% duty had replaced a 6% tax that had clearly been imposed on net income. The change in rates occurred because of administrative difficulties in determining the amount of expense that had actually been experienced by the taxpayers. Cuba cut the rate by 3% as an estimated allowance for the average amount of gross income consumed by operating expense. The tax was still intended to reach net income even though it was imposed on gross income, and the credit was allowed. In this case, the critical fact was the intent of the Cuban Government in levying the tax to reach net income. *Bank of America Trust & Sav. Ass'n v. United States*[25] clarified this perspective. There, the tax was imposed on the gross income of branch banks in Thailand, the Philippines, and Argentina, but the statutes did not allow for the deduction of significant operating expenses, such as indirect bank expenses, rental, or bad debt expense, so the court denied the credit. The court in *Bank of America* held that a direct income tax is creditable even though imposed on gross income, if it is highly likely, or was reasonably intended, always to reach some net gain in the normal circumstances in which it applies. The tax failed this test because the court could not say that the tax would reach, in all probability, net gain.[26]

These cases[27] make clear that a tax may be creditable even if it does not allow for the deduction of all the "normal" expenses that are allowed under the Internal Revenue Code. The

24. 46 B.T.A. 1076 (1942).

25. 459 F.2d 513 (Ct. Cl. 1972), *cert. denied,* 409 U.S. 949 (1972).

26. *Accord,* Bank of America Trust & Sav. Ass'n v. Commissioner, 61 T.C. 752 (1974).

27. *See also* Santa Eulalia Mining Co. v. Commissioner, 2 T.C. 241 (1943), *appeal dismissed,* 142 F.2d 450 (9th Cir. 1944), where a credit was allowed for a Mexican tax imposed upon the gross revenue derived from mining operations in Mexico. The tax in question was withheld from a royalty payment. The court was willing to grant the credit because the subcontractor, in determining the royalty, had already deducted the significant direct operating expenses incurred in mining, and the court was certain that the expenses connected with receiving the royalty were highly unlikely to exceed the amount of the royalty. Thus, the tax in effect was certain to fall on net gain in the United States sense.

courts look beyond the label of a tax to its nature and purpose in making a determination on its creditability. If the court finds that the *purpose* and *effect* of a tax are to reach net income, it will allow a credit despite the fact that the foreign statute does not allow for the deduction of every expense that is normally deductible in this country.

B. *Can a tax be limited to a particular operation, e.g., mining, and still qualify as an income tax?*

In the abstract, nothing prevents a tax on a particular operation, in this case mining, from qualifying for a credit as long as it meets the judicial criteria of an income tax.[28] This conclusion is especially true in cases involving severance taxes on mining output where the activity taxed, the extraction of minerals, results in marketable ore, a thing of value to the operator which was not usable before the mining operation took place. Extracting the ore is somewhat removed from the receipt of income from the sale of that output, but as long as a tax on the extraction is designed to, and does, reach the gain attributable to the mining function resulting in the sale of the ore, the tax on the single operation of mining should be creditable.

Keasbey & Mattison Co. v. Rothensies,[29] one of the leading decisions on the creditability of severable mining taxes, concerned a 4% mining duty imposed by the province of Quebec on all "profits" derived from mining ore in Quebec. The tax was levied on the market value of all output that left the pit's mouth, including both ore sold and ore used by the operator, and thus never resulted in actual profit. The profit was determined by deducting any expense directly related to the mining operation, including the direct salary and material expenses, as well as indirect costs, such as insurance, depreciation and utilities costs, from the aggregate market value of the output. The court disallowed the credit because this tax was not intended or structured to reach any gain from the mining operation, but

28. *See, e.g.*, Havana Electric Railway, Light & Power Co. v. Commissioner, 34 B.T.A. 782 (1936). The Board allowed a credit for a tax imposed by the muncipality of Havana upon the income earned by the utility within the city, even though the company's operations included other functions outside of Havana, and even though the company was also subject to a national income tax. This seems to justify the proposition that as long as the tax in question is an income tax, it makes no difference how the statute limits its operation, either geographically or functionally.

29. 133 F.2d (3rd Cir. 1943), *cert. denied*, 320 U.S. 739 (1943).

was rather intended as a tax on the privilege of removing the minerals from the earth.[30]

American Metal Co. v. Commissioner[31] also involved a tax imposed on the mining operation. The tax was imposed by Mexico on the market value of all output whether the ore was sold or utilized by the operator. Further, the tax allowed no deductions from this total. Under these circumstances (including the fact that the taxpayer had suffered an actual loss for several years but was still subject to the tax in those years), the court denied a credit because this tax was independent of any realized gain that might result from the sale of the minerals.

These cases clarify the creditability of taxes imposed on a particular operation. To be creditable, the tax on the mining operation must conform closely to an income tax as the concept is understood in this country, and cannot be based on the constructive receipt of income fixed at an artificial level such as the market value of the product, apart from the sale of the ore.[32]

This concept is developed further by *New York & Honduras Rosario Mining Co. v. Commissioner*,[33] where a tax on mining operations in Honduras was allowed a section 901 credit. The tax was imposed on "liquid profits" derived from the sale of iron ore extracted from mines in Honduras. The act allowed the deduction of every meaningful expense related to the mining operation, including indirect administrative costs; thus, the tax was intended to reach the gain resulting from the sale

30. Placing a tax on the privilege of removing natural resources from the earth is common, especially in the area of mining. This can only serve to increase the difficulty of classifying an output tax as an income tax within § 901, since the natural place to impose a mining privilege tax is at the point of the privileged activity, *i.e.*, the extraction of the ore.

31. 19 T.C. 879 (1953), *aff'd*, 221 F.2d 134 (2d Cir. 1955).

32. *See also* Rev. Rul. 69-653, 1969-2 C.B. 152, where the I.R.S. reviewed a mining tax imposed by Quebec that was much like the tax disallowed in *Keasbey*. The I.R.S. denied a credit for this tax because the tax was not properly laid upon income (gain derived from labor, capital, or from both combined) but rather included in the tax base nonincome items, such as the market value of ore shipped or consumed by the operator. Nor did it matter that all expenses directly related to the mining function were deductible, since an income tax cannot be levied on items that do not represent gain. It is obvious that any attempt to distinguish *Keasbey* and Rev. Rul. 69-653 from the Ontario tax will fail, since they involved the same features that identify the noncreditable nature of the Quebec mining taxes (they also were levied upon nonincome items such as the value of ore consumed by the operator, and allowed for the deduction of even fewer expenses than were allowed in *Keasbey*).

33. 168 F.2d 745 (2d Cir. 1948); *see also* Rev. Rul. 57-62, 1957-1 C.B. 241.

of the ore. Furthermore, the court recognized that the Honduran tax was distinguishable from the one disallowed in *Keasbey* in that the tax in *Keasbey* was levied on the gross value of output less direct mining expenses, while the Honduran tax included as its base only income actually received through sales, less the total expense needed to generate the sales.[34]

New York & Honduras Rosario Co. indicates that a tax upon the separate mining operation will be creditable only if the tax is imposed on gain actually realized through sale of the output and only if the foreign statute allows for the deduction of every significant expense incurred in producing the mining income. This highlights the importance of the concept of realized gain in section 901. The courts uniformly require that a tax be levied on a base that represents a gain that the taxpayer has received in the form of income.[35] When this principle is applied to the severable mining taxes reviewed here, it becomes clear that section 901 will only extend to taxes imposed on the mining function if the tax is designed to reach only realized gain that is attributable to the mining function, and when the statute is restricted in its base to ore that is intended for sale and not for the operator's use.

IV. CONCLUSION

In Rev. Rul. 78-61, the Internal Revenue Service adopted a restrictive view of section 901 of the Internal Revenue Code. When this ruling is applied to the Ontario Mining tax, the I.R.S. position seems justified, since this tax is nothing more

34. *See also* Santa Eulalia Mining Co. v. Commissioner, 2 T.C. 241 (1943), *appeal dismissed*, 142 F.2d 450 (9th Cir. 1944), where a tax withheld from a royalty payment was allowed as a § 901 credit. The tax withheld was levied upon the gross income derived from the mining operation of the company paying the royalty, and the court allowed the credit because the significant expenses incurred in mining the ore had already been deducted from the income base on which the royalty was paid.

35. *See* Lanman & Kemp-Barclay & Co. of Columbia v. Commissioner, 26 T.C. 582 (1956), where the tax in question was a patrimony tax imposed on the value of a taxpayer's assets, regardless of whether or not the taxpayer actually realized any gain from the use or sale of the assets. The tax, in effect, was levied on appreciation of all property in Colombia even if the appreciation had not been realized through sale. The credit was denied under these circumstances, because

> [t]he doctrine that only those increases in value of property which are actually realized by the owner constitute taxable income is basic to the income tax system of the United States . . . (citations ommitted). "The defined concept of income has been uniformly restricted to a gain realized or a profit derived from capital, labor, or both." (Citing *Keasby.*)

26 T.C. 582, at 587. *See also* Motland v. United States, 192 F. Supp. 358 (N.D. Iowa 1961).

than a tax on the privilege of extracting ore from the mines of Ontario. However, the three strict criteria set forth by the I.R.S. in Rev. Rul. 78-61 may exceed the standards set forth in some of the decisions reviewed here. For instance, the I.R.S. would seem to deny creditability to any tax that fails to provide for the major "normal" expenses that are allowed under the Internal Revenue Code,[36] while *Seatrain, Bank of America,* and *Santa Eulalia* all indicate that the courts are willing to grant a credit to such taxes if they are net income taxes in purpose and effect. Also, the I.R.S. would certainly classify any tax imposed on a separate operation as a privilege or excise tax, while *New York & Honduras Rosario Co.* and *Santa Eulalia* indicate that such a tax should be credited despite its functional limitation if it fulfills the traditional criteria of an income tax.

Looking to the future development of the foreign tax credit after Rev. Rul. 78-61, the restrictive view of the I.R.S. will certainly be the cause of litigation by taxpayers seeking a more generous interpretation of section 901. It is also probable that as the tax considerations of foreign investment decisions increase in importance, lobbying pressure by U.S. nationals in foreign legislatures may cause some countries to restructure their tax laws to conform with this country's Internal Revenue Code. This result will stimulate investment in such countries by allowing U.S. nationals to take full advantage of section 901 in their tax considerations. Thus, in the long run, Rev. Rul. 78-61 may well be an important force in lessening the strife over the proper interpretation of section 901, as it will be a strong impetus toward structural conformity in revenue laws.

36. *E.g.*, in Rev. Rul. 78-61, I.R. Bull. No. 1978-8 11 at 14, the I.R.S. holds that expenses incurred in producing gross income are not inherently so slight as to insure that they will never exceed the gross income, and for this reason, a tax on gross income should not be creditable.

CASE COMMENT

Hard Times for Bounty Hunters: Zenith Radio Corporation v. United States, 98 S. Ct. 2441 (1978)

DWIGHT C. SEELEY*

The long-standing doubts surrounding United States countervailing duties policy were recently unraveled by the United States Supreme Court in *Zenith Radio Corporation* v. *United States* (98 S.Ct. 2441) (1978). Eight years of administrative review and judicial interpretation ended in a denial of Zenith's appeal for countervailing duties to be assessed against imported Japanese electronic products.[1]

Zenith, the large Chicago-based electronics firm,[2] found its original complaint for assessment of duties denied by the Customs Bureau of the Treasury Department. The Treasury policy, backed by some eighty years of administrative precedent, requires a showing that if a foreign producer rebates taxes or fails to tax products upon export, then that rebate must be "excessive," that is, more than the item was initially taxed in the domestic market. If such a rebate is nonexcessive, then it fails to provide the exporter an unfair competitive advantage and therefore will not trigger a countervailing duty against it. The legislative history, economic theories, and prior Supreme Court pronouncements advanced by Zenith proved insufficient to override this longstanding Treasury policy and its reasonableness in light of past and present United States countervailing duty laws. The unanimous Supreme Court opinion consequently upheld the Treasury practice and the economic policy that it reflects.

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1. Television receivers, radio receivers, radio-phonograph combinations, radio-television-phonograph combinations, radio/tape recorder combinations, tape players, record players and phonographs complete with amplifiers and speakers, tape recorders, and parts of television receivers: color television picture tubes, resistors, transformers (deflection components), and tuners for receivers with integrated circuits. 37 Fed. Reg. 10,087 (1972) *as amended by* 37 Fed. Reg. 11,487 (1972).

2. Zenith has also been the standard bearer for the industry in litigating dumping claims against Japanese electronics producers. *See* Zenith Radio Corp. v. Matsushita Elec. Indus. Co., 402 F. Supp. 251 (1975).

Background

In the arena of world trade, a manufacturer faced with an inelastic demand for his product may find that a decrease in domestic price will not increase demand sufficiently to cover the loss in revenue of a price decrease. The manufacturer may well find an elastic demand in a foreign market, where selling at a lower price will stimulate sales and increase profits as well as provide him market penetration. By exporting, his "profits will be maximized by maintaining the high price at home and selling at a lower price abroad."[3] This is dumping, a practice which is specifically outlawed in the United States by the Revenue Act of 1916[4] and the Anti-Dumping Act of 1921[5] as recently amended by the Trade Act of 1974.

Another practice, sharing an "interlocking conceptual basis"[6] with dumping is that of subsidies, usually provided by a foreign government to promote export. Typically, a government makes a political decision to bolster the economic position of a particular group of industries. Reasoning for this may vary. Sometimes the intent is to protect a weak domestic industry already glutted by competition; at other times the purpose is to protect the domestic economy through increased foreign exchange earnings and a stable balance of payment position. Whatever the reason and by whatever method the government chooses to provide the subsidy, the recipient industry becomes more competitive in the world market because of the subsidy and not because it has produced more efficiently.[7] The Countervailing Duties provision of the Tariff Act of 1930[8] provides statutory protection for American industries from this kind of subsidized export. Access to the Anti-Dumping and Countervailing Duty measures has been expedited through the recently expanded concept of judicial review of negative decisions,[9] resulting in a flurry of legal activity. The dumping stat-

3. *See* Meyerson, *A Review of Current Antidumping Procedures: United States Law and the Case of Japan,* 15 COLUM. J. TRANSNAT'L L. 167, 168 (1976).

4. 15 U.S.C. § 72 (1976).

5. 19 U.S.C. §§ 160-173 (1976).

6. Feller, *Mutiny Against the Bounty: An Examination of Subsidies, Border Tax Adjustments and the Resurgence of Countervailing Duty Law,* 1 LAW & POL'Y INT'L BUS. 17, 33 (1969).

7. Butler, *Countervailing Duties and Export Subsidization: A Reemerging Issue in International Trade,* 9 VA. J. INT'L L. 82, 83 (1968).

8. Tariff Act of 1930, § 303, *as amended by* 19 U.S.C. § 1303 (Supp. IV 1974).

9. 19 U.S.C. § 1516(d) (1976).

ute was applied only 77 times between 1954 and 1971, whereas roughly 65 cases were under review from 1971 to 1974.[10] The major thrust of countervailing duty complaints in the 1960's was directed against European Economic Community and Canadian exporters.[11] However, the 1970's have seen Japan assume the position as the leading exponent of dumping. While countervailing duty determinations have been more infrequent,[12] there too the recent activity has concerned Japan, with the case of *Zenith Radio Corporation v. United States*[13] providing the definitive standard for determination of illegal subsidies.

"Japan, Inc."

The pressures of a growing population, racial homogeneity, and a capacity for high productivity have created a business image of Japan as a monolith, where government and industry go hand-in-glove to dominate the world's industries. This image portrays the government as the economic center or "home office" with each industry a branch or division of the corporation. Although this image tends to distort the true picture, principally by minimizing the private activity of the major corporations and the considerable competition between them,[14] there is no arguing that post-war Japan has seen a remarkable consensus of national goals where business and government officials have collaborated to promote economic growth.[15]

With the dismantling of the huge, family-controlled corporations (the *zaibatsu*) and the regulation of monopolistic enterprises under the Occupation, new and independent business initiatives arose. From the beginning, post-war growth was forged by a unique "participatory partnership" where the government defined the economic priorities of the nation, and industries, assisted by a variety of supports and subsidies, endeavored to fulfill them.[16] In the 1950's, the Japanese government's

10. Silbiger, *Trade Act of 1974: New Remedies Against Unfair Trade Practices in International Trade*, 5 DEN. J. INT'L L. & POL'Y 77, 80 (1975).

11. Meyerson, *supra* note 3, at 197.

12. Butler, *supra* note 7, at 126.

13. Zenith Radio Corp. v. United States, 98 S. Ct. 2441 (1978).

14. E. Kaplan, Japan: The Government-Business Relationship 15 (1972).

15. Meyerson, *supra* note 3, at 197.

16. E. Kaplan, *supra* note 14, at 17. The United States Commerce Department analogizes this relationship as one similar to the American government's creation of the Atomic Energy Commission (AEC) and the National Aeronautics and Space Administration (NASA). Because the U.S. government desired certain national goals and

goals centered around the "big four" industries (coal, electricity, marine transportation, and iron and steel) which received top priority and the largest proportion of investment funds.[17] What emerged from that experiment was a rebuilt economy and a government-industrial relationship that mutually strives for what the Ministry of International Trade and Industry (MITI) has called a "concerted economy":

> Out of discussions between the government and private enterprise, mutually determined national targets are worked out. Private enterprise pledges to carry these out. Government, on its side, pledges special favors . . . such as subsidies and taxation measures.[18]

The economic infrastructure, fueled by large scale concessions from the U.S. military during the Korean and Vietnamese conflicts, grew so rapidly that by 1964 the balance of trade between the United States and Japan shifted in Japan's favor and has grown every year thereafter, totaling $3 billion in 1971, just after Zenith filed its complaint.[19]

The rapid expansion of the Japanese economy has not been entirely smooth, however, and the industrial system has developed in such a fashion that domestic troubles (such as a recession) will have international repercussions. For one, a high equity/debt ratio (20.8% versus 44% in the U.S.)[20] has put a continuing burden on Japanese industries. This, combined with a system of lifetime employment with a variety of employee benefits, means that Japanese companies have a high level of fixed costs. These costs encourage a "full capacity policy," which requires each industry to operate at full capacity to recover high fixed costs.[21] Full capacity results in surplus production which will find its way abroad as exports.

In times of stress the planned oligopolistic structure functions poorly. Each industry has its ranking within the domestic economy and will receive its commensurate "market share" in import licensing and borrowing quotas. In a rapid growth pe-

because of the large amounts of capital, high technology and high risk involved, only the government could successfully underwrite such projects.

17. *Id.* at 73, n.11.

18. MITI, Industrial Research Paper #100, "A discussion of Cooperative Industrial Organization," *quoted in* E. HADLEY, ANTITRUST IN JAPAN 398 (1970).

19. E. Kaplan, *supra* note 14, at 6.

20. Meyerson, *supra* note 3, at 198.

21. *Id.* at 198-99.

riod a given industry will grow and invest in production capacity commensurate to its market share and new enlarged credit capacity.[22] Overproduction results when the economy falters, thus:

> in times of recession or when overcapacity results from the corporation investing to protect its market share, the excess produce is sold abroad (even dumped) by the ubiquitous trading sibling as long as the variable costs are recovered, since high fixed costs for debt (interest) and wages (life employment) cannot be avoided anyway.[23]

Consumer electronics, like coal and shipbuilding in the 1950's, has been deemed a "high priority growth industry"[24] in the 1970's and no industry has been more responsive to the need for export marketing.[25] This responsiveness has resulted in a highly defensive stance by various U.S. industries, which has resulted in increased complaints and litigation. Where the decade 1960-1970 saw only six dumping cases lodged against Japan, aggressive sales have catapulted that figure to thirty-two complaints during the four years from 1971 to 1975.[26] In that regard "renewed and continued activity may be anticipated."[27]

The Law

A highly competitive world sugar market aroused the protective instincts of the U.S. Congress which passed the first general countervailing duty statute under the Tariff Act of 1897.[28] This act delegated to the Secretary of the Treasury the power to determine the amount of "bounty" or "grant" by which a foreign government subsidized exports. The Secretary was required to assess a duty equal to that amount. Subsequent enactments in 1909, 1913, and 1930 altered the act only slightly.

The Countervailing Duty Law as it stands today provides

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22. D. HENDERSON, FOREIGN ENTERPRISE IN JAPAN 157 (1975).

23. *Id.*

24. E. Kaplan, *supra* note 14, at 7.

25. "Hitachi (a major electronics firm) has traditionally placed great emphasis on the promotion of exports. *The future development of the company's business is based squarely on export, and this policy is in accord with the requirements of the nation as a whole.*" (Emphasis added.) (1968 annual report.) Zenith Radio Corp. v. Matsushita Elec. Indus. Co., 402 F. Supp. 251, 289 (1975).

26. Meyerson, *supra* note 3, at 197.

27. Silbiger, *supra* note 10, at 80.

28. 30 Stat. 205 (1897).

for the assessment of a special duty on imported merchandise equal to the net amount of any "bounty or grant" paid "directly or indirectly" by a foreign government or other entity with respect to the manufacture, production, or exportation of such merchandise.[29] The administration of section 303 of the Tariff Act of 1930 lies with the Treasury Department[30] which delegates its authority to the Commissioner of Customs.[31] Where investigation shows that a "bounty or grant" exists on dutiable merchandise, the Commissioner is *required* to assess a countervailing duty.[32]

Anyone can invoke the Countervailing Duty Law although it is a domestic producer who generally initiates the investigation.[33] If the Commissioner fails to find a bounty and consequently makes no assessment, the U.S. manufacturer, producer, or wholesaler may contest the no-bounty determination in the United States Customs Court.[34] Failing there, an appeal may be filed with the United States Court of Customs and Patent Appeals,[35] and the Supreme Court may grant *certiorari*.[36] The impact of the Trade Act of 1974 was to extend to American manufacturers the right to contest a no-bounty determination; conversely, foreign producers had rights to a judicial review of an assessment from section 514 of the Tariff Act of 1930.[37]

Although in existence for better than eighty years, the Countervailing Duty statute has been difficult to apply. No statutory language within the law defines what constitutes a "bounty or grant." Nor do the implementing regulations shed any light.[38] Of the two Supreme Court cases before *Zenith* that had taken countervailing duty assessments on review,[39]

29. 19 U.S.C. § 1303(a) (1976).

30. Except for duty free merchandise which will be reviewed by the International Trade Commission. The standard applied there is consistent with a dumping standard—that the item has caused "injury" to a U.S. industry. 19 U.S.C. § 1303(b) (1976).

31. 19 C.F.R. § 159.47 (1977).

32. 19 U.S.C. § 1303 (1976).

33. W. STERLING & D. WALLACE, A LAWYER'S GUIDE TO INTERNATIONAL BUSINESS TRANSACTIONS 132 (2d ed. 1977).

34. 19 U.S.C. § 1516(d) (1976).

35. 28 U.S.C. § 2601 (1976).

36. 28 U.S.C. § 1256 (1976).

37. 19 U.S.C. § 1514 (1976).

38. 19 C.F.R. § 159.41-47 (1977).

39. Downs v. United States, 187 U.S. 496 (1903); and Nicholas v. United States, 249 U.S. 34 (1919).

neither had been explicit enough in its definition to provide reliable precedent for either subsequent court decisions or commentators.[40] A wealth of legislative history can be called upon to support either the position that a "bounty" means only an *excessive* remission or the contrary position that *any* remission constitutes a bounty. Also, the Customs Court in *Zenith v. United States*[41] accepted the *Downs* holding as a viable precedent, while the Court of Customs and Patent Appeals, with two dissents, ruled to the contrary.[42]

The Tax

The difficulty in deciding whether an indirect tax exemption or remission of the type complained of in the *Zenith* case is a bounty or grant lies in the nature of indirect taxes generally. In *Zenith* the tax was a "single stage consumption tax"[43] levied on goods at the manufacturing level. The tax emanates from the Japanese Commodity Tax Law (March 31, 1962, Law No. 48) which sets a consumer tax on items such as television sets.[44] It also provides that previously paid taxes on exempt products (*e.g.*, exports) are refunded.[45] As such it is merely an excise or consumer-type indirect tax, not unlike those of the United States, some of which are remitted upon export.[46]

The classical theory of taxation holds that indirect taxes differ from direct ones in that direct taxes (production and materials taxes, income taxes, etc.) will be absorbed by the manufacturer whereas indirect taxes are fully *shifted forward* to the consumer in the price of the product. It is thought that a seller will raise his prices by the equivalent amount of his indirect tax burden, and the consumer becomes the *de facto* taxpayer.[47] If the tax were not rebated on export, the exported product would be taxed by the exporting country *and*

40. *See e.g.*, that the Supreme Court definition of "bounty" in the *Downs* case is dictum: Butler, *supra* note 7, at 119; and Feller, *supra* note 6. *But see, e.g.*, that the bounty definition is a holding: American Express v. United States, 332 F. Supp. 191, 197-99 (Cust. Ct. 1971); and King, *Countervailing Duties—An Old Remedy with New Appeal*, 24 Bus. L. 1179, 1182-83 (1969).

41. Zenith Radio Corp. v. United States, 430 F. Supp. 242 (Cust. Ct. 1977).

42. United States v. Zenith Radio Corp. 562 F. 2d 1209 (C.C.P.A. 1977).

43. 430 F. Supp. at 242.

44. Way, Brockman & Otsuka, 51-6th T.M., Business Operations in Japan A-44 (1978). On television sets the tax is 15%.

45. *Id.*

46. 26 U.S.C. §§ 4221(a)(2), 6416(b)(2)(A) (1976).

47. Feller, *supra* note 6, at 51.

the importing country, making it noncompetitive when marketed against the importing country's product.[48] Both the General Agreement on Tariffs and Trade (GATT) and the Treasury Department/Customs Bureau are apprised of this potential double taxation. Both hold that a countervailing duty will not be imposed merely because the exporting country has rebated a domestic tax upon export of the product. In fact, if the principles of GATT had been applied to the *Zenith* case, there would have been no appeal since the statutory language of GATT (in Article VI(3)) makes it clear that neither the *exemption* nor the *refund* of an indirect tax by the exporting country will trigger a countervailing duty.[49] However, Article II of GATT recognizes the superiority of prior inconsistent domestic legislation under the protocol arrangement.[50] Thus, since the Tariff Act's Countervailing Duty provision precedes GATT, it is the interpretation of that statutory language along with the Supreme Court decisions that provide the resolution to the *Zenith* case.

The above analysis of indirect taxes is no longer absolute under the modern view, which holds that the forward shifting on indirect taxes is incomplete. Thus a $100 production-cost Japanese television which is assessed at 15% tax would sell for $115 in Japan if the tax were fully shifted forward. However, if the producer sold the item for $110 in the foreign market, the $15 he would receive in remitted tax from exporting his product would be in excess of his indirect tax liability by $5 per unit. Thus, his exports would be subsidized by the government tax remission. In response to the above situation, the U.S. position has been that a countervailing duty will be imposed to the extent that the rebated, indirect tax *is not shifted forward in the cost of the item.*[51]

Since *Zenith* was neither argued from a factual transcript,[52] nor did it evidence the extent to which the Japanese tax was shifted, no economic guidelines were set by any of the

48. *See generally* EXECUTIVE BRANCH GATT STUDIES, SENATE COMMITTEE ON FINANCE, 93rd Cong., 2d Sess., 17-18 (1974).

49. The General Agreement on Tariffs and Trade (GATT), Oct. 30, 1947, 61 Stat. A24, T.I.A.S. No. 1700, 55 U.N.T.S. 187.

50. The "grandfather clause." Protocol of Provisional Application of the General Agreement on Tariffs and Trade, Oct. 30, 1947, art. 1(b), 61 Stat. A 2051, T.I.A.S. No. 1700, 55 U.N.T.S. 308.

51. Butler, *supra* note 7, at 116.

52. The Customs determinations generate no formal hearing record.

three courts which heard the *Zenith* case. It is safe to say, however, that the weight of modern authority supports the theory that indirect taxes are *not* fully shifted forward and direct taxes are not fully shifted backward.[53] To the degree that an indirect tax is even partially shifted backward (that is, absorbed by the manufacturer) a full refund of an indirect tax becomes a subsidy for exports.[54] Also, there is no generally agreed-upon method for determining the degree of discrimination that results from this indirect/direct tax problem.[55] Complex economics, coupled with the divergent goals and methods of economists, have caused the courts to adopt neither of these competing points of view. This is not to say that the courts are not aware of these complexities. There are ample indications that both the Court of Customs and Patent Appeals[56] and the Supreme Court[57] are fully apprised of the negative commentary directed against the economic principles on which the Treasury has based its policy.

Zenith Radio Corporation v. United States (430 F. Supp. 242) (1977)

The *Zenith* case shows the countervailing duty determination procedures through each stage of review. Zenith Radio Company first petitioned the Treasury Department in 1970, alleging that the remission of the Japanese Commodity Tax (on various consumer electronic items) constituted a bounty or grant and asked for an imposition of countervailing duties. The Customs Bureau began an investigation and solicited information from all parties, which ultimately resulted in publication of preliminary findings on February 5, 1975.[58] The notice distinguished three export-inducing programs under which "benefits had been received" which constituted "bounties or grants" within the meaning of section 303 of the Tariff Act. The Commissioner of Customs further stated that the amounts consid-

53. Rosendahl, *Border Tax Adjustments: Problems and Proposals*, 2 LAW & POL'Y INT'L BUS. 85, 109 (1970). *See also* K. DAM, THE GATT—LAW AND INTERNATIONAL ECONOMIC ORGANIZATION, 214 (1970).

54. Rosendahl, *supra* note 53, at 110; and K. Dam, *supra* note 53, at 215.

55. Rosendahl, *supra* note 53, at 112. *See also*, McNamara, *Tax Adjustments in International Trade; The Border Tax Dispute*, 3 J. MAR. L. & COM. 339, 361 (1972).

56. 562 F. 2d 1209, 1219 n. 19.

57. 98 S. Ct. 2441, 2449 n. 14.

58. *See* 37 Fed. Reg. 10,087 (1972) (notice of proceedings) and 40 Fed. Reg. 5,378 (1975) (preliminary determination).

ered were *de minimis*, that is, not excessive and therefore not to be countervailed. Because the program providing the benefits was available to firms capitalized at less than one billion yen, the Commissioner prolonged the investigation in order to determine whether "significant" benefits would accrue to a few smaller firms. On January 7, 1976, a final negative determination was made.[59] The findings showed that two export-inducing programs had been abandoned by the Japanese government. The third involved an aggregate amount considered *de minimis* per dollar value of the exported product. Thus, no countervailing duty was assessed.

Zenith chose to contest the determination, resulting in a plea before the Customs Court for a summary judgment on the matter.[60] Plaintiff Zenith, arguing directly from *Downs* v. *United States*, said that the Supreme Court's decision as well as that of special customs tribunals had repeatedly held that a remission of taxes on exportation constituted a bounty or grant. They buttressed this argument with reference to the legislative history of section 303. The defendant averred that the countervailing duty provision was intended to apply only to "excessive remission of taxes directly related to the imported product."[61] Furthermore, because the Congress had been apprised of the Treasury practice (countervailing only "excessive" remissions), this amounted to a legislative approval of the administrative practice.[62]

The court found for plaintiff Zenith and ordered the Secretary of the Treasury to assess countervailing duties equal to the "net amounts of bounty or grant paid or bestowed."[63]

The court's reading of the 1903 *Downs* case is at the center of the argument. In *Downs* the Supreme Court addressed itself to a tax rebate on sugar exported from Russia. Exporters were not only relieved of the 1.75 rubles per pood[64] domestic excise tax, but received a certificate upon export. This certificate could then be sold to other sugar producers entitling them to the same excise rebate on sugar they sold domestically. The

59. 41 Fed. Reg. 1,298 (1976).
60. 430 F. Supp. at 242.
61. *Id.* at 244.
62. *Id.* at 243.
63. *Id.* at 265.
64. 36.113 pounds avoirdupois. T.D. 22,814, 4 TREAS. DEC. 184 (1901).

critical language of the Supreme Court's decision was straightfoward:

> [T]wo facts . . . appear clearly . . . : that no sugar is permitted to be sold in Russia that does not pay an excise tax of R. 1.75 per pood, and that sugar exported pays no tax at all. . . . When a tax is imposed upon all sugar produced, but is remitted upon all sugar exported, then, by whatever process, or in whatever manner, or under whatever name, it is disguised, it is a bounty upon exportation.[65]

The unequivocal language, taken literally, supports the Custom Court's reading. However, it remains unclear whether the Court in *Downs* condemned the mere *excise remission* or whether the sugar *certificate* was the object of the countervailing duty. The literal reading was cited in a subsequent (1903) Board of General Appraisers (predecessor to the Customs Court) decision and in a House Ways and Means Committee document (1908) where it was understood to mean that an excise remission on exported goods was a bounty.[66] However, the Secretary of the Treasury never interpreted *Downs* in that fashion and subsequent determinations have consistently denied that a tax remission on exports is always a bounty.[67]

United States v. Zenith Radio Corporation (562 Fed. 2d 1209) (1977)

The United States Court of Customs and Patent Appeals, in a case the majority called "first impression," would not accept the Customs Court's reading of *Downs* and reversed the decision. The lower court's reading, said the majority opinion, was to take the straightforward language of the *Downs* decision out of the context of the facts—that there was a *dual* benefit in the Russian remission-and-certificate scheme. The original Board of General Appraiser's opinion had noted the combination of the two benefits. The Board and the appellate courts were faced with a "decision resting not on either of two independent grounds but on a single ground having at least two important elements."[68] Therefore, there was no need for the court to decide whether a nonexcessive remission was a *per se*

65. 187 U.S. at 515.

66. 430 F. Supp. at 245.

67. Butler, *supra* note 7, at 120 n. 188. The Secretary interpreted the *Downs* case as requiring a refund *plus* something else of *cash value* in order to trigger countervailing duties.

68. 562 F. 2d at 1213.

bounty or grant. In the context of the entire opinion, then, the strong language cited by the Customs Court was not necessary to the decision and was not the *ratio decidendi*.[69] Additional findings of the majority included: (1) that Congress has not required that every remission constitute a bounty, as demonstrated by the refusal to define "bounty" or "grant" in the statute; (2) that while legislative history can be cited for either position, there is nothing to indicate a congressional intent that countervailing duties be imposed in response to "non-excessive remissions";[70] and (3) that a long-continued administrative practice is entitled to great weight, particularly when Congress has failed to revise the statute while on notice of the administrative practice.[71]

That Congress has acquiesced to the administrative practices of the Treasury was, in the opinion of dissenting Judges Miller and Baldwin, a myth. Moreover, (1) the case was not one of first impression because the key language has been dealt with by the Supreme Court before; (2) the interpretation of the Court in *Downs* was holding, not dictum; and (3) judicial interpretation prevails over any long-continued administrative practice.[72]

As the Customs Court decision had done before, the dissenters zeroed in on the unequivocal language cited in *Downs* but referred to by the majority as "unnecessary." To bolster the argument that *either* the remission or the certificate would classify as a bounty the dissenters quote the language in the *Downs* decision referring to the export certificate as an *additional* bounty:

> If the additional bounty paid by Russia upon exported sugar were the result of a higher protective tariff upon foreign sugar, and a further enhancement of prices by a limitation on the amount of free sugar put upon the market, we should regard the effect of such regulations as being simply a bounty on production, al-

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69. *Id.* at 1215.

70. *Id.* at 1217.

71. The government argued that if the *Downs* case held as Zenith claimed it did, the Secretary's interpretation nevertheless emerged supreme. Because the Secretary did not change his interpretation after either the *Downs* or *Nicholas* cases and because Congress—with full knowledge of the Secretary's practice—continued to re-enact the statute without substantive change, Congress in effect "overruled" *Downs* and *Nicholas* insofar as they conflicted with the Secretary's practice. Reply Brief for Appellant at 6-7, United States v. Zenith Radio Corp., 562 F. 2d 1209 (C.C.P.A. 1977).

72. 562 F. 2d at 1223.

> though it might incidentally and remotely foster an increased exportation of sugar; *but where in addition to that these regulations exempt sugar exported from excise taxation altogether,* we think it clearly falls within the definition of an indirect bounty upon exportation.[73] (Emphasis added.)

The dissenters concluded that both the remission and the certificate were bounties. Also referred to is the definition provided by the Supreme Court itself in the 1919 countervailing duty case *Nicholas & Co.* v. *United States.* There, bounties were determined to have been granted on whiskey and gin exported from Great Britain and countervailing duties were assessed. In interpreting the relevant statute the Court wrote:

> If the word "bounty" has a limited sense the word "grant" has not. A word of broader significance than "grant" could not have been used. Like its synonyms "give" and "bestow" it expresses a concession, the conferring of something by one person on another. And if the "something" be conferred by a country "upon the exportation of any article or merchandise" a countervailing duty is required . . .[74]

In the *Nicholas* case as well as other subsequent decisions[75] the courts relied on the broad language used in *Downs* to justify assessment of duties. Likewise, the majority in the Court of Customs and Patent Appeals was mindful of the "subsequent references to broad statements"[76] made in *Downs.* Nevertheless, the majority was not swayed by this line of interpretation. The court's decision left to the Secretary of the Treasury that "lawfully permissible"[77] discretion which the Secretary has exercised since—and perhaps despite—the *Downs* decision.

Zenith Radio Corporation v. United States (98 S. Ct. 2441) (1978)

The Supreme Court decision wholly embraced the thinking of the C.C.P.A. majority on the three contested issues: (1) the correct interpretation of the statutory language and legislative history of section 303; (2) the *Downs* holding; and (3) the economic effects of the remission of the Japanese tax. As the Supreme Court's findings parallel those of the C.C.P.A. on

73. 187 U.S. at 513.
74. Nicholas & Co. v. United States, 249 U.S. at 39.
75. *See, e.g.,* American Express Co. v. United States, 332 F. Supp. 191 (Cust. Ct. 1971), *aff'd on other grounds* 472 F. 2d 1050 (C.C.P.A. 1973).
76. 562 F. 2d at 1215.
77. *Id.* at 1223.

both law and policy, the lower court's decision is unanimously affirmed.

The opinion of Justice Marshall clearly delineates two principles that govern the Court's thinking. First, because of the long-standing Treasury interpretation of the statute and congressional "acquiescence" to this interpretation, the C.C.P.A. had correctly affirmed the interpretation as "lawfully permissible"[78] within the language of section 303. Second, the Court found no rule emanating from *Downs* which explicitly decided the question whether "nonexcessive remission of taxes, standing alone, would have constituted a bounty on exportation."[79] The Court went on to rule on a third issue, that the Treasury's interpretation was "reasonable" in light of the "economic result" of the Japanese tax remission. Actually, as petitioner Zenith had based its cause of action squarely on its interpretation that *Downs* declared a tax remission, upon exportation, as a *per se* bounty or grant, this third issue as to the reasonableness or arbitrariness of the Treasury policy was never put into contention.[80] The fact that the Supreme Court sought to identify it (as had the C.C.P.A.) as fundamental to the resolution of the issue, shows that the decision also had strong roots in economic policy.

Statutory Interpretation

The Court noted that the Treasury had adopted its interpretation of the 1897 statute the following year[81] and that that interpretation has been both unchanged and consistent in application since that time. Such a long-standing statutory interpretation by an administrative agency is entitled to "considerable weight."[82] That interpretation has "particular weight" when the administrative practice involves a "contemporaneous construction of a statute" by those "charged with the responsibility of setting its machinery in motion."[83] Additionally, as the Department's interpretation

78. *Id.*

79. 98 S. Ct. at 2451.

80. Brief for the United States in Opposition at 11 n. 9, Zenith Radio Corp. v. United States, 98 S. Ct. 2441 (1978).

81. May 6, 1898 in T.D. 19321, 1 Synopsis of Decisions 696 (1898). *See* Brief for the United States in Opposition at 6 n. 4.

82. Udall v. Tallman, 380 U.S. 1, 16 (1965), quoting Unemployment Compensation Commission v. Aragon, 329 U.S. 143, 153 (1946).

83. Norwegian Nitrogen Products Co. v. United States, 288 U.S. 294, 315 (1933); *see, e.g.*, Power Reactor Co. v. Electricians, 367 U.S. 396, 408 (1961).

was "sufficiently reasonable," it was acceptable to a reviewing court.[84] In summary the Court finds:

> Our examination of the language, the legislative history, and the overall purpose of the 1897 provision persuades us that the Department's initial construction of the statute was far from unreasonable; and we are unable to find anything in the events subsequent to that time that convinces us that the Department was required to abandon this interpretation.[85]

Petitioner Zenith's claim that the statute is clear and unambiguous by a plain meaning approach to the language is implicitly rejected by the Court's broader view of the legislative activity that forged the statute.

Legislative History

The Marshall opinion zeroed in on two critical periods in the murky legislative history of this act. The first target of analysis concerned the subtle changes brought about when the first act, an exclusively sugar-protecting provision in 1890,[86] was expanded to cover general imports in 1897. While no definition of "bounty or grant" was provided by any of the measures as enacted, there is evidence that supporters[87] of the measure intended to countervail only against "net" bounties (where monies rebated upon export exceeded the domestic excise tax). Such subsidization schemes were then practiced by "several" European governments.[88] This concept was more explicitly covered in the 1894 Act which excepted American importers from duties on bounty-fed exports where those importers could produce a certificate from the exporting government that "*no indirect bounty has been received upon said sugar in excess of the tax collected upon the beet or cane*

84. Train v. Natural Resources Council, 421 U.S. 60, 75 (1975).

85. 98 S. Ct. at 2445.

86. Tariff Act of 1890, 26 Stat. 584.

87. Appellant U.S. Government maintained in its reply brief before the C.C.P.A. that "Statements of sponsors are to be accorded substantial weight in the interpretation of a statute." Reply Brief for Appellant at 4, United States v. Zenith Radio Corp., 562 F. 2d 1209 (C.C.P.A. 1977). The Government advanced a similar argument before the Supreme Court. Brief for the United States in Opposition at 11 n.8, Zenith Radio Corp. v. United States, 98 S. Ct. 2441 (1978). This point was contested by Zenith, but the Supreme Court did not address it in the opinion. Instead, the Court relied on statements made by both sides in the floor debates insofar as both sides were in accord as to the amounts of countervailing duties discussed. This obviated the need to rely on the sponsor's intentions.

88. 98 S. Ct. at 2446.

from which it was produced."[89] (Emphasis added.) Although the same provision was not incorporated into the 1897 Act, the term "net amount of such bounty or grant"[90] was incorporated. By that phrase the concept of "net bounty" was transposed from the 1894 to the 1897 Act, and in so doing the intent was "to incorporate the prior rule that nonexcessive remission of indirect taxes would not trigger the countervailing requirement at all."[91]

Second, the Court studied the Senate floor debates surrounding the passage of the 1897 Act. The Senate debate makes clear the intention to countervail only against excess remissions and provides an illustration of the concept through a German export scheme then under scrutiny. The House version of the 1897 Act had in fact utilized explicit language concerning countervailing against only "net" bounties on exported sugar. That language was deleted in the Senate (and final) version because the Senate wished to expand the coverage of the act to all imports, not merely sugar.[92] The offending German scheme concerned a "bounty" on exported raw and refined sugar. The "bounty" figures used in the debates were 38¢ per hundred pounds of refined sugar and 27¢ per hundred pounds of raw sugar. Consequently, the countervailing duties under discussion were in the same amounts. But the crucial fact revealed in the debates was that the full amount remitted from domestic consumption tax upon export from Germany was *$2.16 per hundred pounds*. It follows from this discrepancy that the figures of 38 and 27 cents must have been what the Treasury had determined to be the "excess" or "net" bounty; otherwise if remission of the entire indirect tax were regarded as the "bounty," the necessary duty would have to have been the full $2.16.[93]

Downs Revisited

Ultimately, the resolution to the *Zenith* case rests upon the *Downs* decision. The Court acknowledges that "this would be a very different case"[94] if the Secretary's interpretation were

89. Paragraph 182½ of the Act of August 27, 1894. Tariff Act of 1894, 28 Stat. 521.

90. Section 5 of the Tariff Act of July 24, 1897, 30 Stat. 205.

91. 98 S. Ct. at 2446.

92. 30 CONG. REC. 1635 (1897).

93. 98 S. Ct. at 2447.

94. *Id*. at 2449.

contrary to the Court's holding in *Downs*.

The facts in that case revealed two relevant tax adjustments: (1) the remission of excise taxes on sugar exported from Russia, and (2) receipt of a valuable certificate upon export, this certificate relieving the exporter of excise taxes on his sugar sold domestically. The issue that came before the *Downs* Court was whether a nonexcessive remission of indirect tax together with the granting of an additional benefit (the certificate) constituted a "bounty or grant."[95] Because petitioner Downs, the importer, did not challenge the amount of the duty assessed on the sugar by the Treasury, the Court's attention was not concentrated on the distinction between the mere remission of the tax and the certificate. Thus, Zenith arrived at court arguing that a mere remission alone was sufficient to trigger a countervailing duty. They bolstered their argument with the same broad language used in *Downs* that had proven persuasive in the Customs Court.[96]

The modern Court finds this passage wholly incompatible with language in *Downs* both preceding and subsequent to the general language in *Downs*. The *Downs* Court understood the "bounty" to refer to the certificates, as had the Board of General Appraisers[97] and the Fourth Circuit Court of Appeals[98] before it. The *Downs* Court, equally concerned with the "economic effect" of the disputed activity as the modern Court, noted:

"The amount he [the exporter] receives for his export certificate, say, R. 1.25, is the *exact amount of the bounty he receives upon exportation,* and this enables him to sell at a profit in a foreign market."[99] (Emphasis added.) Further, the *Downs* Court went on to specifically concur with the conclusion of the Fourth Circuit, which it incorporated verbatim into its own opinion:

> We find that the Russian exporter of sugar obtains from his government a certificate, solely because of such exportation, which is worth in the open markets of that country from R. 1.25 to R. 1.64 per pood, or from 1.8 to 2.35 cents per pound. Therefore we

95. *Id.* at 2450.
96. *See* note 65 *supra.*
97. T.D. 22,984, 4 TREAS. DEC. 405, 410-11, 413 (1901).
98. Downs v. United States, 113 Fed. 144, 145.
99. Downs v. United States, 187 U.S. 496, 515.

> hold that the government of Russia does secure to the exporter of that country, as the inevitable result of its action, a money reward or gratuity whenever he exports sugar from Russia.[100]

The occurrence within the same page of the same opinion of statements that have given rise to legal arguments for the opposing sides in the *Zenith* case is what makes *Downs* an "admittedly opaque opinion."[101] Nevertheless, the weight of the evidence does not allow the modern Court to take the broad statements relied upon by Zenith as the holding of the *Downs* decision. Because no one argued in *Downs* that a mere remission by itself constituted a bounty, and because the Court did in fact support the Secretary's decision countervailing only as against the excess remission,[102] the Court finds that "the isolated statement in *Downs* relied upon by petitioner cannot be dispositive here."[103]

Economic Effects

Both petitioner Zenith and respondent U.S. Government supported their legal points with economic and policy arguments. The Court was much less definitive in its discussion of these issues than in its clean-cut resolutions to the interpretation of the legislative history and the *Downs* holding. While the Court did not deny the validity of Zenith's position, it did not alter its affection for the reasonable nature of the Treasury policy.

The main thrust of Zenith's economic argument was that the Treasury policy is based on outdated economic theory which favors foreign tax structures. The Supreme Court acknowledged that remissions of indirect taxes may be in fact an incentive to export.[104] Additionally, such remissions as sanctioned by GATT may work to the detriment of those countries relying primarily on direct taxes (as the United States) and to the advantage of those dependent on indirect taxes (as Japan). Thus, where indirect taxes are a primary revenue source, foreign exporters "are able to receive tax rebates on exportation far greater than U.S. exporters, without fear of countervailing under either the GATT rules, or the countervailing duty law as

100. *Id.* at 516.

101. 98 S. Ct. at 2450.

102. T.D. 22,814, 4 TREAS. DEC. 184 (1901). The final sums assessed against the Russian sugar ranged from .38 ruble per pood to .50 ruble per pood.

103. 98 S. Ct. at 2451.

104. *Id.* at 2449.

it traditionally has been construed by the Treasury Department."[105] The possible competitive advantage gained by foreign producers has been fully debated in Congress. Legislative dissatisfaction with present policy has resulted, *inter alia,* in some protectionist language from the Senate Finance Committee[106] and promulgation of Section 121(a)(5) of the Trade Act of 1974, which mandates presidential action on a revision of GATT articles "with respect to the treatment of border adjustments for internal taxes to redress the disadvantages to countries relying primarily on direct rather than indirect taxes."[107] Although cognizant of the dissatisfaction, the Court bows to the complexity of the economic situation and states that "given the present state of economic knowledge" it would be difficult to measure the effect of the remission of indirect taxes.[108] Nor does the Court think it wise to substitute its judgment for that of the Secretary in economic matters.[109] Clearly the Court feels the economics of the issue are too nebulous for judicial resolution and therefore does not defeat Zenith's arguments so much as side-step them.

Economics aside, the Court feels the successful application of the Treasury policy over eight decades has been reasonable. That policy has sought to analyze a tax remission or other subsidy in terms of its economic effect on the United States. The policy is best encapsulated in the C.C.P.A. analysis: "Neither form nor nomenclature being decisive in determining whether a bounty or grant has been conferred, it is the economic result of the foreign government's action which controls."[110] In fact, the analysis is a balancing test; measuring the effect of the offending practice against the purpose of countervailing duty legislation. Indeed the history of judicial review of countervailing duty cases contains both of these themes.[111]

105. Marks & Malmgren, *Negotiating Non-tariff Distortions to Trade*, 7 LAW & POL'Y INT'L BUS. 327, 352 (1975).

106. "[T]he United States can no longer stand by and expose its markets, while other nations shelter their economies . . . with . . . export subsidies . . . and a host of other practices which effectively discriminate against U.S. trade and production." S. REP. No. 1298, 93rd Cong., 2d Sess. 19 (1974).

107. Trade Act of 1974, § 121(a)(5), adding 19 U.S.C. § 2131. *See generally,* Marks & Malmgren, *supra* note 105, at 354-355.

108. 98 S. Ct. at 2449.

109. *Id.*

110. 562 F.2d at 1216.

111. *See, e.g.*, T.D. 22,984 at 414; and *Downs*, 187 U.S. at 514-515.

The modern Court notes that while the legislative history might not be such as to *compel* a Treasury policy against only "net" bounties, there is no question of the reasonable nature of the policy "in light of the statutory purpose."[112] The statutory purpose of countervailing duties is to control and negate the competitive advantage gained through export subsidization. In holding that nonexcessive remissions of indirect taxes did not sponsor the competitive advantage that the legislation was enacted to prevent, the Treasury acted "in accordance with the shared assumptions of the day as to the fairness and economic effect of that practice."[113] Thus the Secretary's policy, based on assumptions still current if not fully subscribed to by all observers, remains as permissible today as it was in 1898.

The Future of Countervailing Duty Policy

The immediate effect of the Supreme Court decision is twofold: (1) to lend judicial sanction to the "lawfully permissible" countervailing duties policy of the Treasury Department, and (2) to distinguish *Downs* as *not* holding that all remissions of indirect taxes are bounties or grants. While the latter result would certainly deny future petitioners their strongest legal precedent in cases with similar facts, it does not necessarily follow that countervailing duty complaints will decrease. Indeed, as the last decade has seen a marked increase in countervailing duty reviews, there is the strong likelihood that the combination of economic pressures and the increased accessibility of the courts will result in a commensurate upsurge in litigated complaints. This trend may focus needed light on the Treasury's review procedures, which have often been criticized for delay and secrecy.

The *Zenith* case was a pointed illustration of agency foot-dragging. Eight years elapsed between the filing of Zenith's complaint and the rendering of the Supreme Court decision; nearly six years was spent in administrative investigation and review. Fortunately, Congress addressed that situation directly in the Trade Act of 1974 while *Zenith* was still under review. The Secretary of the Treasury is now obligated to decide if a

112. 98 S. Ct. at 2448.
113. *Id.*

foreign country has bestowed a bounty or grant within twelve months of the filing of a complaint.[114]

Certain to come under renewed scrutiny is the wide range of Treasury discretion, uninhibited by the need to produce a factual record to justify bounty or no-bounty determinations. As it stands today, when the Treasury imposes or denies a countervailing duty claim, only the fact of the bounty or grant is published along with the amount assessed against it, if any. As noted by the C.C.P.A., this profoundly circumscribes judicial review as there are no transcripts from which a reviewing court can determine whether the Secretary's findings were supported by the evidence or if they were in fact arbitrary or capricious. The Administrative Procedure Act[115] allows for such a review and Congress does provide for hearings in antidumping cases,[116] but in countervailing duty review the Treasury is not reached by either.[117] This deficiency leads to the incongruous situation faced by the C.C.P.A. in the *Zenith* case where it acknowledged, on the one hand, that it is the economic effects of a foreign government's action that determine whether a subsidy has been bestowed, and on the other hand, that in the *Zenith* case "the record is silent regarding the economic result of the mere remission of the Japanese Commodity Tax."[118] This says, in effect, that the court maintains a standard of judgment but receives no facts to apply to the standard. In the *Zenith* case, the C.C.P.A. presumed[119] that the economic result of the Japanese tax did not confer a subsidy, and then went on to decide whether the Treasury policy was justifiable as a matter of law. Faced with the same lack of data, the Supreme Court merely notes that the debate over the economic effects of remitted indirect taxes is far from over,[120] and faced with the complexity of the issues it is "not the task of the judiciary to substitute its views as to fairness and economic effect for those of the Secretary."[121] It would seem improbable that this "it's-fair-because-the-Secretary-says-it's-fair" reasoning will stand

114. Trade Act of 1974 § 331(a), adding 19 U.S.C. § 1303(a)(4).

115. 5 U.S.C. § 551-559 (1976).

116. 19 U.S.C. § 160(d) (1976).

117. 562 F.2d at 1216, n.13.

118. *Id.* at 1216.

119. *Id.*

120. 98 S. Ct. at 2449.

121. *Id.*

without challenge. Such a challenge would likely emerge in the situation where a complainant wished to contest the data which forms the basis of the final judgment whether a remission was "excessive" or not.

From the point of view of a prospective litigator, *Zenith* provides little guidance to the standard of what constitutes a bounty or grant. True, this very definition is a major policy decision and should be the responsibility of congressional legislation and executive (Treasury) interpretation and application. However, as Congress has avoided a fixed definition, and the facts and pleadings of the *Zenith* decision are hazy as to how the Treasury determinations are made, it would follow that it is the responsibility of the courts to provide some standards against which the petitioner can measure his chances for successful review.

On the other hand, it can be strongly argued that the effect of an arbitrary standard defined by statute would be detrimental to U.S. trading flexibility. This line of reasoning would allow the Treasury the widest discretion possible in its determinations so as to strike a better balance between the changing economics and politics of international trade and U.S. interests. The judicial support that the *Zenith* decision lends to the Treasury's practices has at its base a very compelling policy rationale. The entire countervailing duties area is undermined by a haunting specter, which like the Treasury policy is a legacy of 1898—the fear of economic retaliation leading to a protective tariff war.

Because the imposition of countervailing duties is *required* by the statute upon a finding of a bounty or grant; because there need be no factual showing of "injury" to a domestic industry; and because judicial review is subject to the aforementioned limitations, some would view the imposition of countervailing duties as a "sleeping giant"[122] with a dangerous potential to disrupt the flow of world trade. In a 1971 countervailing duties case the C.C.P.A. cautioned: "Countervailing duties are strong medicine, well calculated to arouse violent resentment in countries whose trade practices are branded by

122. Davis, *The Regulation and Control of Foreign Trade*, 66 COLUM. L. REV. 1428, 1446 (1966).

the court as unethical."[123] The desire to avoid incitement of "violent resentment" from one of America's foremost trading partners is the overriding theme of the government's policy arguments in *Zenith*. In its brief before the Supreme Court, the government urged the Court to view the facts and policies in the same light as the Secretary in order to avoid a "significant breakdown" in American trading relations and "retaliatory actions" from trading partners. It also pleaded for favorable review so as not to undermine the government's "negotiating flexibility" in the 1978 Multilateral Trade Negotiations (under the auspices of the GATT).[124] Additionally, any decision which would encourage a wider application of countervailing duties (in response to a worsening balance of payments deficit or import glut) as has been predicted[125] would certainly be contrary to the spirit and language of GATT and likely put a severe strain upon that system.[126] There is a strong inference to be drawn from the decision in the *Zenith* case that a factor in the Court's approval of the Treasury practice was the Secretary's restraint in applying the duties pursuant to the congressional grant of the discretion to determine what constitutes a bounty or grant. It is for this reason that "bounty" or "grant" have no statutory definition, indicating Congress' intent to refrain "from calling all the countervailing duty plays in advance."[127]

Conclusion

In refusing to grant Zenith's request for reversal of a negative determination on Japanese electronic goods, the Supreme Court has established two significant guidelines. Future complainants who contest a no-bounty determination will no longer have the broad language of the *Downs* decision to cite as precedent. Also, potential litigators are on notice that the Treasury policy that refuses to assess duties against nonexcessive remissions has been given full approval by a unanimous Court. What remains to be clarified is a Treasury standard for "bounty" or "grant" which is sufficiently well-defined to pro-

123. United States v. Hammond Lead Products, Inc., 440 F.2d 1024, 1031 (C.C.P.A. 1971).

124. Brief for the United States in Opposition at 7-8, Zenith Radio Corp. v. United States, 98 S. Ct. 2441 (1978).

125. King, *supra* note 40, at 1192.

126. Rosendahl, *supra* note 53, at 122.

127. 562 F.2d at 1217.

vide guidance for potential complainants as well as to reviewing courts.

Most significant in *Zenith* is the lack of evidence in the language of the statute, or in eighty years of legislative history, judicial review, and administrative practice, that could convince the Court that the broad powers of countervailing duty determinations should not be left to Treasury discretion. Holding that the Treasury policy is "lawfully permissible" under the statute is little more than saying that this discretionary power has been reasonably exercised. The Congress, long aware of the Treasury practices, has made no effort to overrule them. The Treasury practice is also compatible with the GATT system. The *Zenith* decision merely adds the judicial imprimatur to the Treasury policy.

In so doing, the Court puts the countervailing duties problem in a broad international perspective. Countervailing duties come to us from the late 19th century, a time when protective tariffs were commonplace and retaliatory legislation was the first response called for by U.S. industries, particularly a nascent one as was the sugar industry at the turn of the century. Similarly, massive imports of highly competitive Japanese consumer electronic goods had the U.S. industry reeling in the early 1970's. Continuing problems of a similar nature require constant bilateral negotiations at the highest executive level between the United States and Japan. The *Zenith* decision, more than just another comment on *Downs,* lends judicial backing to the Secretary's attempts to balance the anger of domestic industry against the export necessities of a major trading partner and ally. The Court's decision minimizes the effect an arbitrary standard might have on world trade and continues the discretionary license the Treasury has exercised since the creation of the statute.

BOOK NOTES

Foreign Legal Systems

ELKIND, J., THE IMPACT OF AMERICAN LAW ON ENGLISH AND COMMONWEALTH LAW, A BOOK OF ESSAYS; West Publishing Company, St. Paul, MN 55012 (1978); LC 77-089013; xvii, 362 pp.; appendices, table of cases, index.

This compendium traces the influence that American law, both judicially and legislatively created, has had on the laws of England and members of the Commonwealth. The book does not purport to be an exhaustive survey, but highlights the adoption of aspects of American law by English law. The essay also gives an overview of the areas in which English common law has had an effect on American law.

MERRYMEN, J.H., & CLARK, D.S., COMPARATIVE LAW: WESTERN EUROPEAN AND LATIN AMERICAN LEGAL SYSTEMS; CASES AND MATERIALS; The Bobbs-Merrill Co., Inc., Indianapolis, New York, and Charlottesville, Virginia (1978); ISBN 0-672-83379-4; xlvii, 1278 pp.; index, table of readings, table of tables, list of foreign abbreviations. Contemporary Legal Education Series. Preface by M. Cappelletti.

The authors introduce the civil law system including variations contributed by Latin America. Attention is given to Latin America's intellectual history, structure, legal education, and legal profession. Procedures, rules, and pleading and proof of foreign law are included.

NEWCITY, M., COPYRIGHT LAW IN THE SOVIET UNION; Praeger Publishers, 200 Park Ave., New York, NY 10017 (1978); LAW 346'.47'0482 76-12867, ISBN 0-275-56450-9; 212 pp.; appendix, bibliographical references, index.

Newcity gives a brief background of copyright law in Tsarist Russia and examines the current copyright law of the Soviet Union, including personal and property rights and remedies afforded authors in a totalitarian legal framework. The book considers developments and controversies since Soviet accession to the Universal Copyright Convention (UCC) in 1973. Of particular interest are the rights of internal dissidents publishing in the Soviet Union and abroad, and the general East-West exchange of information and literary and scientific works, both before and after accession to the UCC. Included in the appendix are the copyright provisions of the USSR Fundamentals of Civil Legislation and of the RSFSR Civil Code as amended through October, 1976.

Human Rights

AMNESTY INTERNATIONAL, POLITICAL IMPRISONMENT IN SOUTH AFRICA; Amnesty International Publications, 10 Southampton Street, London WC2E-7HF (1978); available in the U.S. from Amnesty International U.S.A., 2112 Broadway, New York, NY 10023; $2.00; ISBN 0-900058-70-6; 108 pp.

This Amnesty International publication is a recent contribution to the growing international effort to protect basic human rights. The report is a result of Amnesty International's study of the widespread use of torture by the South African regime to silence conscientious opposition to apartheid. *Political Imprisonment in South Africa* gives profiles of seven prisoners of conscience and describes the South African legal structure created by the government to consolidate white political power and social and economic privilege and foreclose effective black opposition.

International Business and Taxation

DREVER, J.S., HABERLER, B., & WILLETT, T.D. (editors), EXCHANGE RATE FLEXIBILITY; American Enterprise Institute for Public Policy Research, 1150 Seventeenth Street, N.W., Washington, D.C. 20036 (1978); $5.75 (also available in cloth, $10.75); ISBN 0-8447-2124-7, ISBN 0-8447-2123-9 pbk.; 288 pp. AEI Symposia 78-C.

The volume contains the edited 1976 proceedings of the Conference on Exchange Rate Flexibility and the International Monetary System, cosponsored by the American Enterprise Institute and the United States Treasury Department. The first three sessions of the conference evaluated the initial performance of the new international monetary systems of flexible exchange rates. The fourth and fifth sessions centered attention on two issues facing this system, the international surveillance of exchange rates and balance of payments policies, and the management and control of international liquidity.

International Organizations

WORKERS' EDUCATION AND ITS TECHNIQUES; ILO Publications, International Labour Office, DH-1211 Geneva 22, Switz. (1976); ISBN 92-2-100195-4 (paper); 199 pp.; appendices, index, references.

This is a training manual in the purposes, scope, and techniques of workers' education. Primarily for underdeveloped countries, it is the International Labour Office's response to trade unionists' need for a modern guide to educating the worker-student in practical areas such as trade unionism, labor legislation, industrial relations, and economic and social democracy.

International Politics and Government

CERNY, K.H. (editor), GERMANY AT THE POLLS: THE BUNDESTAG ELECTION OF 1976; American Enterprise Institute for Public Policy Research, 1150 Seventeenth Street, N.W., Washington, D.C. 20036 (1978); $4.75; ISBN 0-8447-3310-5; 208 pp.; footnotes, tables, maps, index, contributors. Appendix on recent Bundestag election statistics.

The 1976 elections in the Federal Republic of Germany demonstrate the emergence of a strong two-party system in that country, according to seven German and three U.S. scholars. The book analyzes the narrow victory of the coalition of the Social Democratic party and the Free Democratic party (over the opposition coalition of the Christian Democratic Union and Christian Social Union). The development of the four major parties, the eight elections since the Federal Republic was formed in 1949, and the impact of the four nationwide newspapers are discussed by the various authors.

CLEMENS, W., THE U.S.S.R. AND GLOBAL INTERDEPENDENCE: ALTERNATIVE FUTURES; American Enterprise Institute for Public Policy Research, 1150 Seventeenth Street, N.W., Washington, D.C. 20036 (1978); $3.25; ISBN 0-8447-3292-3; 113 pp.; footnotes, index, tables. AEI Foreign Affairs Study Series No. 190.

Professor Clemens analyzes the trends and political implications of Western trade and detente with the Soviet Union. Despite suspicion on both sides, Clemens sees a trend toward global cooperation. Policy stances in the Soviet Union are grouped into four categories: detente and trade, globalism (subordination of national interests), forward strategy (exploitation of Western weaknesses), and autarky (isolationism). Clemens argues that at least limited participation by the Soviet Union in international programs is needed in an interdependent world.

PENNIMAN, H.R. (editor), IRELAND AT THE POLLS: THE DAIL ELECTIONS OF 1977; American Enterprise Institute for Public

Policy Research, 1150 Seventeenth Street, N.W., Washington, D.C. 20036 (1978); $4.75; ISBN 0-8447-3300-8; 199 pp.; footnotes, glossary, tables, maps, index, appendices, contributors.

Ireland at the Polls was written by four of Ireland's leading political scholars: Basil Chubb, Brian Farrell, Maurice Manning, and Richard Sinnott. The focus of the selections is the Irish general election of 1977 where the Fianna Fail Party triumphed over the incumbent National Coalition of the Fine Gael and Labor Parties. The authors analyze Irish society, its political and electoral systems, and the 1977 campaign and election. Included are discussions of the history of Irish political parties and the media coverage of the campaign. The conclusions encompass reasons for the surprising outcome of the election, the effects of that outcome, and prospects for the future of Ireland.

RANNEY, A., & SARTORI, G. (editors), EUROCOMMUNISM: THE ITALIAN CASE; American Enterprise Institute for Public Policy Research, 1150 Seventeenth Street, N.W., Washington, D.C. 20036 (1978); $4.75; ISBN 0-8447-2135-2 (ISBN 0-8447-2135-4 pbk.); 196 pp.; footnotes, tables. AEI Symposia 78-G.

Twelve noted American and Italian scholars and politicians discuss the influence of communism on Europe, focusing on Italy. The papers, presented at a conference sponsored by the American Enterprise Institute and the Hoover Institution, cover the "opening to the left in the 1960's," the Italian Communist party, and current Italian politics.

The papers cover the broader area of Eurocommunism, including the Spanish and French communist parties, and compares them to traditional Marxism-Leninism. Sections analyze the foreign policy of the United States in this regard and make suggestions for the future.

WEINER, M., INDIA AT THE POLLS; American Enterprise Institute for Public Policy Research, 1150 Seventeenth Street, N.W., Washington, D.C. 20036 (1978); $3.75 (paper); ISBN 0-8447-3304-0, LC 78-15030; 150 pp.; footnotes, tables, maps, index, appendices. Studies in Political and Social Processes. With special assistance of N. Desai, R. Berrier, and P. Brass.

Myron Weiner gives a firsthand account of the campaign leading to the historic defeat of the authoritarian rule of Indira Ghandi's Congress party government. The Opposition leaders, most of them newly released from jail, united to form the Janata party and campaigned on the single issue of restoring democracy. From his analysis of the returns Weiner concludes that, beyond the striking and unexpected north/south cleavage, the most notable pattern was the absence of any significant variations between urban and rural India. The author further assesses the effects of these developments in the party system of India on elections held since March, 1977.

United States Foreign Policy

AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH, THE ROLE OF THE JOINT CHIEFS OF STAFF IN NATIONAL POLICY; American Enterprise Institute for Public Policy Research, 1150 Seventeenth Street, N.W., Washington, D.C. 20036 (1978); $2.00 (paper); ISBN 0-8447-2138-7, LC 78-64988; 42 pp. AEI Forum 21.

An edited transcript of a Round Table held on August 2, 1978, including John Charles Day, Moderator; General George S. Brown, Senator John C. Culver, Dr. Curtis W. Tarr, and General Maxwell D. Taylor. This brief history and current analysis of the Joint Chiefs of Staff emphasizes measures needed to improve its operation as an advisor to the leadership of a civilian-managed government. Topics include interservice rivalry within the Joint Chiefs, the all-volunteer army, and the quality of advice given to civilians.

COFFEY, K.J., MANPOWER FOR MILITARY MOBILIZATION; American Enterprise Institute for Public Policy Research, 1150 Seventeenth Street, N.W., Washington, D.C. 20036 (1978); $2.75; ISBN 0-8447-3291-5; 47 pp.; footnotes.

Coffey presents the problems associated with an All-Volunteer Force and how this may seriously affect the NATO obligations of the United States. The author examines the ability of the United States to deploy units on short notice and the extent of combat-ready replacements.

The study attributes most manpower deficiencies to recruiting policies. Coffey concludes with possible corrective actions, costs, and their political consequences.

PALMER, B.K. (editor), GRAND STRATEGY FOR THE 1980'S; American Enterprise Institute for Public Policy Research, 1150 Seventeenth Street, N.W., Washington, D.C. 20036 (1978); $3.25; ISBN 0-8447-3294-X, LC 78-57065; 113 pp.; footnotes, Forward by Robert J. Pranger.

Report examining the United States' need for a central strategy to coordinate its disjointed interests, including national defense. This study, which consists of related articles by five former top ranking military officers, addresses such issues as national arms policy, strategic guidelines for the United States, and a comparison of Soviet strategy and U.S. counterstrategy, with a view to the next decade.

World Peace

DEBENEDETTI, C., ORIGINS OF THE MODERN AMERICAN PEACE MOVEMENT, 1915-1929; KTO Press, A Division of Kraus-Thompson Organization Ltd., Route 100, Millwood, New York 10546 (1978); ISBN 0-527-22070-1; xv, 281 pp.; footnotes, bibliographic essay, preface. KTO Studies in American History.

Charles DeBenedetti describes the social philosophy of the peace movement—its factions and coalitions—during the crucial stages from World War I to the ecomomic crash of 1929. The major groups include internationalists, legalists, and peace reformers (including feminists, pacifists, and Protestant clergymen). The book analyzes the aims of the participants, such as strengthening the World Court, international arbitration, and the League of Nations.

DeBenedetti, a professor of history at the University of Toledo, approaches the topic from a social and historical perspective. He discusses attempts to build one coalition for peace, the conflicts of the individuals (between peace and other values), and the philosophical struggle to harmonize strong nationalism in America with a viable peace movement.