DESCRIPTION OF TAX PROVISIONS

PRECLUSION OF STATE AND LOCAL TAXATION OF PERSONAL PROPERTY IN FOREIGN TRADE ZONES (SECTION 211(B) OF H.R. 3398)

AND

DENIAL OF FEDERAL TAX DEDUCTIONS FOR ADVERTISING CARRIED BY CERTAIN FOREIGN BROADCASTERS (S. 1940)

Scheduled for a Markup Before the

SENATE COMMITTEE ON FINANCE

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INTRODUCTION

The Senate Finance Committee has scheduled a markup on November 7, 1983, on various measures, including two tax provisions. One provision (section 211(b) of H.R. 3398, which is identical to S. 1411 (introduced by Senators Byrd, Bentsen and Tower)), would make it clear that States and localities cannot impose property taxes on certain tangible personal property located in foreign trade zones. The second provision, S. 1940 (introduced by Senators Danforth, Mitchell, Evans, Bentsen, Gorton, Moynihan, Cohen, Heinz, Wallop, Symms, and Baucus), would deny deductions for expenses paid to a foreign broadcaster for advertising directed primarily to United States markets if the foreign broadcaster were located in a country that denied its taxpayers a deduction for advertising directed to that country and carried by United States broadcasters. The bill "mirrors" a Canadian provision, and Canada is apparently the only country to which the bill would now apply.

Part I of this document provides a summary of these tax provisions. Part II is a more detailed description of section 211(b) of H.R. 3398, including present law, prior legislative consideration, issues, effective date, and revenue effect. Part III is a more detailed description of S. 1940, including background, present law, issues, effective date, and revenue effect.

I. SUMMARY

Preclusion of State and Local Taxation of Personal Property in Foreign Trade Zones (section 211(b) of H.R. 3398)

Under current law, U.S. customs duties do not generally apply to imports brought into foreign trade zones. States and localities may seek to impose personal property taxes on personal property located in foreign trade zones. The bill would make it clear that States and localities cannot generally impose property taxes on personal property held in foreign trade zones that is (1) produced outside the United States or (2) both produced in the United States and held for export. The bill would not restrict the rights of States and localities to tax machines, equipment, and other property used in foreign trade zones for manufacturing or other processing.

Denial of Federal Tax Deductions for Advertising Carried by Certain Foreign Broadcasters (S. 1940)

Background

In 1976, the Canadian Parliament enacted legislation denying tax deductions for Canadian income tax purposes for advertisements directed primarily at Canadian markets and carried by non-Canadian broadcasters. Presidents Carter and Reagan determined that this Canadian tax rule unnecessarily burdened U.S. commerce under Section 301 of the Trade Act of 1974. Each of them suggested retaliation along the lines of S. 1940, described below.

Present law

Ordinary and necessary advertising expenses paid or incurred by a U.S. taxpayer in the conduct of a trade or business are generally deductible whether incurred in the United States or abroad. In certain limited situations, however, tax results of foreign-related transactions depend on the identity of the foreign nation involved. Examples of harsher tax results include the following: Foreign persons subject to U.S. taxation whose countries tax U.S. persons at discriminatory rates or at rates higher than U.S. rates may owe more taxes than they would otherwise owe (secs. 891 and 896); certain conduct by a foreign nation may make articles produced therein ineligible for the investment tax credit in the hands of a U.S. purchaser (sec. 48(a)(7)); and participation or cooperation by a country in an international boycott will cause U.S. taxpayers who support the boycott to lose certain tax benefits (secs. 908, 952, and 995).

S. 1940

The bill would deny deductions for expenses of advertising primarily directed to U.S. markets and carried by a foreign broadcaster, if the broadcaster were located in a country that denied its taxpayers a deduction for advertising directed to its markets and carried by a U.S. broadcaster. Although the bill does not mention Canada by name, Canada is the only known country to which the bill would apply.

II. PRECLUSION OF STATE AND LOCAL TAXATION OF PERSONAL PROPERTY IN FOREIGN TRADE ZONES

(Section 211(b) of H.R. 3398)

A. Present Law

In general, merchandise may be brought into a foreign trade zone without being subject to the customs laws of the United States (the Foreign Trade Zones Act of 1934, 19 U.S. Code sec. 81a et seq.). Merchandise may generally be stored, sold, exhibited, broken up, repacked, assembled, distributed, sorted, graded, cleaned, mixed with foreign or domestic merchandise or otherwise manipulated in a foreign trade zone, or be manufactured in a foreign trade zone, without being subject to U.S. customs laws, and it may then be exported or destroyed without being subject to U.S. customs laws. This exemption does not apply to machinery and equipment that is imported for use (for manufacturing or the like) within a foreign trade zone.

When foreign merchandise moves from a foreign trade zone into customs territory of the United States it is subject to the laws and regulations of the United States affecting imported merchandise. Thus, current law provides a deferral of U.S. import duties during the period when merchandise is held in a foreign trade zone.

A similar deferral of U.S. import duties applies to goods stored in government supervised, bonded customs warehouses, which are generally treated as being outside U.S. customs territory. Only if goods are withdrawn for domestic sale or stored beyond a prescribed period does any duty become due. The Supreme Court of the United States has ruled that Congress's comprehensive regulation of customs duties preempts state property taxes on goods stored under bond in a customs warehouse (_Xerox Corp. v. County of Harris, Texas, and City of Houston, Texas_, No. 81-1489, December 13, 1982).

Local taxing jurisdictions in Texas may seek to impose property taxes on some tangible personal property stored in foreign trade zones. The staff is not aware of any States or localities outside the State of Texas that seek to impose property taxes on tangible personal property located in foreign trade zones for bona fide customs reasons.

B. Prior Legislative Consideration

On August 11, 1983, the Subcommittee on International Trade of the Senate Committee on Finance requested comments from the public with regard to various bills, including S. 1411. On October 21, 1983, the Subcommittee held hearings on various measures, including S. 1411. On June 28, 1983, the House passed H.R. 3398, section 211(b) of which is identical to S. 1411. Along with other items, this provision (originally introduced as H.R. 717) was the subject of hearings in the Subcommittee on Trade of the House Committee on Ways and Means on April 27, May 5, and May 10, 1983; the Committee on Ways and Means issued its Report on H.R. 3398, H. Rep. No. 98-267, on June 24, 1983.

C. Issues

Section 211(b) of H.R. 3398 raises the following general issues:

(1) Should Congress specifically preclude States and localities from taxing imported personal property that taxpayers hold in foreign trade zones for bona fide customs reasons?

(2) Should Congress preclude States and localities from taxing U.S.-produced personal property that taxpayers hold in foreign trade zones for export?

(3) Should Congress preclude States and localities from taxing U.S.-produced personal property that taxpayers hold in foreign trade zones for combination with imported goods and for later reintroduction into the United States?

D. Explanation of Provision

The bill would amend section 15 of the Foreign Trade Zones Act of 1934 to make it clear that tangible personal property imported from outside the United States and held in a foreign trade zone for the purpose of storage, sale, exhibition, repackaging, assembly, distribution, sorting, grading, cleaning, mixing, display, manufacturing, or processing, and tangible personal property produced in the United States and held in a zone for exportation, either in its original form or as altered by any of the above processes, would be exempt from State and local ad valorem taxation. Thus, the bill would preempt State law or local law imposing ad valorem taxation on such property.

As for imported goods, the benefits of the bill would apply only to goods in a foreign trade zone for bona fide customs reasons. That is, it would not apply to property imported into the United States for use in manufacturing within a foreign trade zone (rather than for sale). Moreover, the Foreign Trade Zone Act of 1934 does not apply to machinery and equipment within a zone for use therein, so the benefits of the bill would not extend to those items whatever their origin.

As for U.S.-produced property, the benefits of the bill would apply only if the property were held in the zone for exportation. The benefits would not apply to U.S.-produced property that was present in the zone for combination with imported property or for other processing if the U.S.-produced property were destined for later use in or sale into the United States. By contrast, the benefits would apply to U.S.-produced property that was present in the zone for combination with imported property or for other processing if the U.S.-produced property were destined for later use or sale outside the United States.

E. Effective Date

The bill would take effect on January 1, 1983.

F. Revenue Effect

It is estimated that this bill would not have a significant effect on budget receipts.

III. DENIAL OF FEDERAL TAX DEDUCTIONS FOR ADVERTISING CARRIED BY CERTAIN FOREIGN BROADCASTERS (S. 1940)

A. Background

In 1976, the Canadian Parliament amended the Canadian tax law to deny deductions, for purposes of computing Canadian taxable income, for an advertisement directed primarily to a market in Canada and broadcast by a foreign television or radio station (Bill C-58, enacted and codified in Income Tax Act of Canada, sec. 19.1). This provision, which supplemented a similar provision for print media, became fully effective in 1977. The purpose of this provision was to strengthen the market position of Canadian broadcasters along the U.S.-Canadian border. The Canadian Government officially views the tax provision as a means of protecting the Canadian broadcast industry, whose goal is "to safeguard, enrich and strengthen the cultural, social and economic fabric of Canada."[1]

At the time Canada adopted this provision, the United States and Canada were renegotiating the income tax treaty between the two countries. The Treasury Department negotiators raised U.S. concerns with the Canadians, but the Canadian negotiators apparently refused to discuss this provision.[2]

After the Canadian Parliament passed the provision denying foreign broadcasting deductions, the U.S. Senate approved a resolution finding that the provision appeared to inhibit commercial relations between Canadian businesses and U.S. broadcasters, and asked the President to raise the issue with the Canadian Government.[3] In addition, some broadcasters filed a complaint under section 301 of the Trade Act of 1974, 19 U.S.C. 2411(a)(2)(B). The complaint alleged that the Canadian provision was an unreasonable practice that

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[1] Statement of Canadian Government Position Concerning Complaint (under Section 301 of the Trade Act of 1974) of U.S. Television Licensees Relating to Section 19.1 of Canadian Income Tax Act, <u>citing</u> Canadian Broadcasting Act of 1968.

[2] <u>Tax Treaties, Hearings before the Senate Committee on Foreign Relations</u>, 97th Cong., 1st Sess. 36 (September 24, 1981) (testimony of John B. Chapoton, Assistant Secretary of the Treasury for Tax Policy); Bureau of National Affairs, <u>Daily Report for Executives</u>, No. 97 at G-5 (May 16, 1980) (reporting testimony of Donald Lubick, Assistant Secretary of the Treasury for Tax Policy).

[3] S. Res. 152, 95th Cong., 1st Sess., 123 <u>Cong. Rec.</u> S14349 (1977).

burdened U.S. commerce. On September 9, 1980, President Carter determined that the provision unreasonably and unnecessarily burdened U.S. commerce, reported an estimate that the Canadian provision was costing U.S. broadcasting $20,000,000 annually in lost advertising revenues, and suggested legislation along the lines of this bill (S. 1940). On November 17, 1981, President Reagan sent a message to the Congress concurring in President Carter's views. On May 14, 1982, the Senate Finance Committee held hearings on S. 2051, a bill virtually identical to S. 1940. On July 26, 1982, the Subcommittee on Trade of the House Committee on Ways and Means held a hearing on H.R. 5205, a bill virtually identical to S. 1940. Congress took no further action on those bills in 1982.

B. Present Law

Deductibility of advertising expenses

Under present law, taxpayers may generally deduct, in computing their Federal income tax, all ordinary and necessary expenses paid or incurred in carrying on any trade or business. The reasonable cost of advertising, whether paid to a domestic or foreign entity, generally qualifies as a deductible ordinary and necessary business expense under Code section 162.

Tax results dependent on the identity of a particular foreign country involved

Under present law, the income tax consequences of a transaction involving a foreign country ordinarily do not depend on the particular foreign country involved. However, the Internal Revenue Code[4] provides in a number of cases for more burdensome income tax treatment for foreign-related transactions on the basis of the laws or policies of the particular foreign country involved. These rules have the effect of adversely affecting taxpayers from a particular foreign country or of discouraging U.S. taxpayers from dealing with a particular foreign country or its persons.[5]

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[4] In addition to the Code provisions discussed in the text, the bilateral tax treaties to which the United States is a party alter Federal tax rules for transactions involving the United States and the treaty partner in varying degrees. For instance, absent a treaty, interest paid by a U.S. borrower is ordinarily subject to a 30-percent withholding tax if the interest income is not effectively connected with a U.S. trade or business of the lender. Some treaties reduce this rate below 30 percent, while some treaties eliminate the tax altogether.

Several specific Code sections allow higher taxation of foreign taxpayers from particular countries. For example, there are two alternative remedies that the President may invoke against taxpayers from a foreign country that taxes United States persons more heavily than its own citizens and corporations. When the President makes a finding that a foreign country's tax system discriminates against U.S. persons, he is to double the applicable U.S. tax rate on citizens and corporations of that foreign country (sec. 891). Alternatively, upon a finding of intransigent discrimination against U.S. citizens and corporations, the President is to raise U.S. tax rates on citizens, residents, and corporations of the discriminating foreign country substantially to match the discriminatory foreign rate, if he finds such an increase to be in the public interest (sec. 896). In addition, if the President finds that a foreign country intransigently taxes U.S. persons more heavily than the United States taxes foreign persons, he is to increase the U.S. tax rates on U.S.-source income of residents and corporations of the high-tax foreign country to the pre-1967 rates if he finds such an increase to be in the public interest (sec. 896). These provisions have apparently never been used.

Moreover, U.S. taxpayers may have to pay higher taxes because of transactions involving certain countries. the President, by executive order, may eliminate the investment tax credit on articles produced in a country that engages in discriminatory acts or policies unjustifiably restricting United States commerce (sec. 48(a)(7)).[6] The power to eliminate the investment tax credit as a retaliatory measure was aimed in part at a number of countries that discriminated in favor of locally produced motion pictures.[7]

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[5] By contrast, some tax rules favor dealings with specific countries. For example, convention expenses incurred in Canada or Mexico receive more favorable treatment than similar expenses incurred in other foreign countries, and convention expenses incurred in certain Caribbean Basin countries are eligible for more favorable treatment in certain cases (sec. 274). In addition, certain corporations formed under the laws of Canada or Mexico will, if the U.S. parent elects, be permitted to join in the U.S. consolidated return of their parent companies (sec. 1504(a)). Moreover, a mutual life insurance company with branches in Canada or Mexico may elect to defer taxation on income of those branches until its repatriation (sec. 819A).

[6] This provision has apparently never been applied. Recently, however, Houdaille Industries of Florida sought application of this provision, but the United States Trade Representative announced on April 22, 1983, that the U.S. Government had decided to deny the relief that Houdaille sought (19 Tax Notes 467, May 2, 1983).

In addition, taxpayers participating in or cooperating with an international boycott generally lose certain tax benefits--the foreign tax credit and tax deferral under the rules governing controlled foreign corporations and Domestic International Sales Corporations--allocable to their operations in or connected with countries involved in a boycott (sec. 999). Unlike the previously described rules, the international boycott provisions of the Code do not necessarily require a finding or decision by any person in the executive branch of government. Although the Secretary of the Treasury maintains a list of countries requiring participation in or cooperation with an international boycott, the absence of a country from this list does not necessarily mean that the country is not participating in an international boycott.

C. Issues

The bill, S. 1940, raises the following general issues:

(1) Is it appropriate to deny tax deductions to U.S. persons who incur ordinary and necessary business expenses for advertising directed primarily at U.S. markets through Canadian broadcast media?

(2) Will retaliatory denial of tax deductions for use of Canadian broadcast media to reach U.S. markets prompt repeal of the discriminatory Canadian provision denying deductions for use of U.S. broadcast media to reach Canadian markets?

D. Explanation of the Bill

S. 1940 would deny taxpayers any deduction for expenses of advertising carried by a foreign broadcast undertaking and directed primarily to a market in the United States, but would apply only to foreign broadcast undertakings located in a country that denies a similar deduction for the cost of advertising directed primarily to a market in the foreign country when placed with a United States broadcast undertaking. Although the only known country to which the bill would now apply is Canada, the bill does not mention Canada by name, and it would apply to any other country that had a tax provision similar to Canada's.

If Canada repealed its rule of nondeductibility, the bill would have no further application to Canada from the

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[7] See S. Rept. No. 437, 92nd Cong., 1st Sess. (1971), reprinted in 1972-1 C.B. 559, 573-74 n. 1.

effective date of the repeal.[8] That is, on the first day that a Canadian taxpayer could make a deductible payment to a U.S. broadcaster for advertising directed primarily to a Canadian market, a U.S. taxpayer could make a deductible payment to a Canadian broadcaster for advertising directed primarily to a U.S. market.

Under the bill, the term "broadcast undertaking" includes, but is not limited to, radio and television stations. Transmission of video programming by cable would also be considered a broadcast undertaking.

The bill would disallow deductions for foreign-placed advertising only if the advertising were directed primarily to a United States market. Whether advertising is primarily directed to a United States market would be a question of intent. In the event of a dispute, objective determination of subjective intent could depend on a number of factors, which could include the geographic range of the broadcast, the distribution of population within that geographic range, the proximity of the advertiser's place of business to the border, whether the purchaser of the advertised product or user of the advertised service would ordinarily come to the advertiser's place of business (or whether the advertiser conducted a mail-order sales business or a mobile service business), and even the nature of the broadcast program the advertiser sponsored (e.g., a sporting event featuring teams from only one of the two countries).

The bill would automatically become effective without any finding or action by the executive branch (although the Secretary of the Treasury could announce those countries to which the bill applied). The determination of the nondeductibility of advertising expenses accordingly would be made in the first instance by the taxpayer, who would be expected on his return to reduce his deduction for advertising expenses by the amount of such expenses paid or incurred to foreign broadcasters for advertising directed primarily to U.S. markets through broadcast undertakings located in a discriminating country.

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8 It is, of course, unclear whether Canada would repeal its rule in the face of this bill. The use of U.S. broadcasters by Canadian advertisers affected by the Canadian legislation would likely have been greater than the use of Canadian broadcasters by U.S. advertisers who would be affected by the bill. S. Rept. No. 402, 95th Cong., 1st Sess. 1 (1977). The Canadian Parliament may believe that Canada retains a comparative advantage even upon enactment of the bill, and political factors might also be important.

E. Effective Date

The provisions of the bill would apply to taxable years beginning after the date of its enactment.

F. Revenue Effect

This bill is expected to increase budget receipts by less than $5 million annually.