MINUTES
CABINET COUNCIL ON COMMERCE AND TRADE
Meeting #52, January 26, 1983
8:45 a.m., Roosevelt Room

Attendees: Messrs. Baldrige, Brock, Wright, McNamar, Niskanen, Wallis, Lovell, Dederick, Wunder, Trent, Harper, Gunn, Darman, Pratt, McMinn, Olmer, DeMuth, Garfinkel, Baroody, Cicconi, Byler, Dr. Anderson, Ms. Risque, and Ms. Small

Financial Interest and Syndication Rule

Secretary Baldrige led a discussion of whether the Administration should support a recision of the financial interest rule for FCC syndication. Associate OMB Director, Chris DeMuth noted that the economic and competitive environment within which the rule had been developed had changed significantly in recent years. He suggested that the original justification for the rule was no longer present. It was the sense of the Council that the current rule restricted competition and was therefore undesirable. No decision was taken as to whether or not the Administration would take a position. However, it was agreed that Commerce and Justice would file their comments with the FCC.

Steel

Under Secretary Olmer led a discussion of the Administration's policy concerning restraint agreements with U.S. trading partners on steel. He suggested that the negotiation of restraint agreements by the U.S. could result in the cartelization of global steel trade. Ambassador Brock outlined specific steel trade problems relating to Brazil and Japan facing the Administration. Ambassador Brock contended that a flexible negotiating approach would give him maximum leverage with these countries. CEA member Niskanen stated his view that it was important that the arrangement with the E.C. on steel be viewed as an anomaly rather than a rule. The Council agreed that the establishment of a pattern of bilateral restraint arrangements would be undesirable.

Office of Strategic Trade

Secretary Baldrige summarized the proposal introduced by Senator Garn to establish an Office of Strategic Trade. Secretary Baldrige noted that a number of organizational and manpower changes had been made to respond to concerns regarding the Commerce Department's administration of export controls policy.

It was agreed by the Council that the Administration should oppose the Garn Bill.

Labor-Management Dialogue

Deputy Labor Secretary Malcolm Lovell proposed that the Council recommend that the President appoint a distinguished individual from outside the Administration to form a high level panel of labor and management leaders to find ways to reduce tensions and enhance cooperation between management and labor. Deputy Secretary Lovell emphasized that the panel would have no government representatives or involvement. CEA member Niskanen expressed concern that the panel would develop recommendations that would result in government involvement or which the Administration would not favor.

Action Taken: It was agreed by the Council that a memorandum setting forth the proposal would be sent to the President.

UNITED STATES GOVERNMENT

memorandum

DATE: 2 JUN 1983

REPLY TO ATTN OF: Mark S. Fowler, Chairman
Federal Communications Commission

SUBJECT: Special Representative for International Telecommunications

TO: James W. Cicconi
Special Assistant to the President
Special Assistant to the Chief of Staff

I. Executive Summary

As you may recall, last year I brought to your attention an important international telecommunications issue - Radio Marti. I believe there is a matter of even greater importance and urgency that should be brought to your attention today. Now pending before the House is the State Department authorization bill, H.R. 2915. Section 116 of this bill would reorganize the international telecommunications functions of the Executive Branch by assigning these responsibilities to the State Department. I have no doubt that such a reorganization would lead to a policy which deemphasized the important trade and national security aspects of international telecommunications.

A few weeks ago I recommended your support for a small White House office to coordinate and direct the various executive branch agencies with international telecommunications interests. The current discord is the product of the Carter Administration executive order assigning responsibilities to State, Commerce, and USIA. H.R. 2915 would exacerbate a bad situation by assigning all responsibilities to State.

By taking away the responsibilities of Commerce and USIA, the bill will not promote harmony but further discord. Secretary Baldridge is opposed and Charles Wick, while not expressing an opinion when I spoke with him since he had not seen the bill, is likely to be opposed.

Our opposition to this bill is based on the shift in emphasis that it implies. It is essential that we recognize the importance of telecommunications in international commerce and trade. Its high growth rate will likely make it our number one export sector in the near future. With its high growth and the position of U.S. firms in this industry, we must recognize the important contribution telecommunications goods and services can make to our overall balance of trade, to economic growth, and in creating new employment opportunities. In my opinion the shift of responsibility to State will reduce the importance of trade and commerce in the decision making process. It will generate new turf wars, a prospect that hardly is appealing.

H.R. 2915 has passed the House Committee and is pending consideration by the full House. S.1342, the Senate authorization bill, has passed the Committee without consideration of the House language on international telecommunications responsibility. The Senate bill is scheduled for full Senate action on June 13. As things now stand, S.1342 will pass without consideration of this matter. The difference will be worked out in Conference Committee. My concern is that in the absence of explicit consideration, the Senate conferees will accept the H.R. 2915 language. If successful, the House would reorganize telecommunications responsibilities without Executive Branch review. This administration must take control of this important matter.

Recommended Actions

I. Eliminate Section 116 of H.R. 2915.

a. OMB should be directed to alert Congress that this provision is not in accord with the Administration's program.
b. Contact Bob Michel about Administration opposition.
c. Contact Senator Percy to request Senate opposition. At a minimum Senate conferees should have instructions to oppose reorganization.

II. Revise executive orders of Carter Administration.

II. Discussion

The provision of telecommunications services and equipment has rapidly become one of the most important segments of the U.S. economy and is a major export commodity. In 1980 the U.S. exported $25 billion in information merchandise. In addition, telecommunications services were responsible for a substantial part of our 1980 total for all service exports of $60 billion. By 1990 telecommunications equipment and services may very well be our most important export. While the expanding international telecommunications market presents clear trade opportunities, complex regulatory, national security and foreign policy issues also exist. It is therefore imperative that we develop at the earliest possible date a fully coordinated international telecommunications policy which will best serve the varied interests of the United States.

At the present time the Federal Communications Commission (FCC) regulates the provision of international communications services and the construction by U.S. carriers of international communications facilities (satellite and submarine cables) under the Communications Act of 1934 and the Communications Satellite Act of 1962. The FCC's jurisdiction over other aspects of international telecommunications, particularly the manufacture and sale of telecommunications equipment is, at most, limited. International trade issues are primarily addressed by the Commerce Department, the STR and the State Department. The State Department is also concerned with the foreign policy aspects of global communications systems and services. DoD is a major user of international communications services and USIA is particularly concerned with the free flow of information.

In carrying out its statutory mandate to provide for the public convenience and necessity, the FCC considers the international trade, national security and foreign policy aspects of a matter within its statutory jursidiction by soliciting and considering the views of the Commerce Department, the STR, NTIA, DoD, USIA, OMB, and the State Department. Unfortunately, these Executive Branch agencies have different objectives and do not always speak with one voice. The net result of the FCC's limited jurisdiction and the conflicting interests of the Executive Branch agencies is an international telecommunications policy which is too often uncoordinated and ineffective. Thus, the private sector does not always know where to turn for policy direction; foreign governments can not discern U.S. policy positions and often receive conflicting policy signals; preparation for international conferences is neither sufficient nor well directed; conflicts between agencies are not easily resolved; public and private sector expertise is not efficiently utilized; and confidence in the U.S. as a world leader in international telecommunications matters is adversely affected.

During the last three years, the Executive Branch agencies have failed to establish a coordinated telecommunications position on a variety of issues. Several of these issues were on matters being considered by the FCC.

- In one case concerning a Comsat application for the provision of a specialized service to DoD, an issue of national security was raised. DoD argued that national security considerations were present and therefore justified special Commission relief. Yet, NTIA submitted its view that no unique or exceptional national security considerations existed.

- In another case involving the first major use of fiber optic transmission equipment, DoD indicated that procurement of fiber optic cable from a foreign supplier would have undesirable national security implications. Yet, the State Department indicated its belief that foreign supply of the cable under the terms of the contract would raise no significant national security problems.

- In a third instance, it appeared that several Nordic governments were about to take action to frustrate the FCC's procompetitive initiatives. The FCC brought this problem to the attention of the Executive Branch. The result was the formation of a task force headed by OMB which authored a report. Unfortunately, OMB may have sent a confusing signal to the Nordic administrations. The matter was finally resolved after a direct exchange between the FCC and the Nordic administrations requiring the personal efforts of Chairman Fowler.

- In a fourth case, the FCC and our Canadian counterparts determined that domestic rather than Intelsat satellites could economically provide U.S./Canada service. However, it took almost a full year to get the necessary clearance from the State Department.

° In another instance, bilateral discussions between the FCC and representatives of the United Kingdom on procompetitive communication policy initiatives have been complicated as several Executive Branch agencies have become involved.

° Most recently, a U.S. delegation was faced with a highly politicized International Telecommunications Union (ITU) meeting in Nairobi, Kenya. U.S. contingency planning efforts for this meeting did not include the formulation of an alternative entity to carry out the ITU's technical responsibilities. Moreover, basic planning for this major conference was delayed to the point of hindering U.S. participation.

Many of the requirements and standards for the provision of communications services and the sale of technology and equipment are established in international organizations. The major operational and equipment standard setting organizations are the two branches of the ITU: the International Radio Consultative Committee (CCIR) and the International Telegraph and Telephone Consultative Committee (CCITT). The standards for networks and equipment established in the study groups of the CCIR and CCITT have a major impact on determining which nations and/or companies will have the lead in certain high technology fields. CCITT and CCIR decisions clearly influence the exportability of products, our balance of payments, and have national security and foreign policy implications. It is therefore important for both the FCC and the Executive Branch agencies that a coordinated policy be timely developed. It is equally important for the United States to take an active role in developing standards and establishing policies in the CCITT and CCIR at the study group level. Only in this manner will the varied U.S. interests be most effectively protected and advanced. In sum, a well coordinated U.S. international telecommunications policy which is based on the input of the FCC, the Executive Branch and the private sector can have a positive impact on our trade, regulatory, foreign policy and national security interests.

The development of a coordinated and effective international telecommunications policy is important for regulatory, trade, national security and foreign policy reasons. Moreover, because other nations have targeted telecommunications as a growth industry, the U.S. response: must have the support of the highest levels of government; must be well articulated; and must be enunciated by a single voice.

To achieve this goal, several options exist.

° First, the status quo could be retained: the FCC and the executive branch agencies would continue to act independently. Coordination would occur on an ad hoc basis when necessary through formal filings, informal meetings or a senior interagency group.

- Second, responsibility for international telecommunications policy coordination could be placed within an existing executive branch agency such as the Commerce Department or the State Department.

- Third, a multiagency task force could be established to formally oversee policy coordination.

- Fourth, a special representative for telecommunications matters could be established. This fourth option generally tracks the proposal found in S.999, the International Telecommunications Act of 1983.

Retention of the status quo as proposed in the first option is clearly undesirable. While no new entity or any reorganization would be required, past performance indicates that neither informal meetings nor the existing senior interagency group have been able to speedily and comprehensively resolve existing policy problems. The second option would end the long running turf battle between State and Commerce. However, it probably would increase agency rivalry and result in the development of a policy best characterized by a particular parochial viewpoint. The third option seeks to obtain the broad input of all impacted agencies. However, the resolution of conflicting views in a timely manner would not be easily achieved in a consensus seeking task force with no clear leadership or decision-making procedures. Such organizations simply do not effectively operate in situations where time is often of the essence.

The fourth option appears to be the best approach. A special representative with a small staff and access to the expertise of all other agencies could coordinate U.S. policy in a timely and efficient manner. A flexible approach to policy coordination outside of the limited jurisdiction of the FCC and the parochial orientation of the existing executive branch agencies is the best alternative to the present ad hoc system. As the policy coordinating body for all international telecommunications matters, the special representative would have the ability to call upon the expertise of the private sector, to establish interagency task forces, and to create working groups with both private sector and public sector members. The special representative could be established under executive order and be part of the White House. The major difference between this proposal and S.999 is that the formation and use of a task force and advisory committee are mandatory under S.999 but optional in this alternative. This streamlined personnel and operational structure would create an entity which could address all international telecommunications issues, coordinate U.S. positions, and articulate U.S. policy with a single voice.

The importance of international telecommunications and existing major problems in policy formation necessitate a fresh look at existing structures and procedures. A new Executive Branch entity, streamlined for efficiency and authorized to coordinate policy upon consideration of the views of the public and private sectors, is workable, necessary and should be implemented.

Mark

Mark S. Fowler
Chairman

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

MEMORANDUM

TO: Jim Cicconi

FROM: Peter Madigan / OMB Legislative Affairs

SUBJECT: Section 116, H.R. 2915, Department of State Authorization Act FY'84&85

Please find attached materials, pertaining to Section 116 of State's Authorization for fiscal years 1984 and 1985. I hope that this will answer any questions that you may have.

1.) Copy of Statement of Administration Policy on H.R. 2915.

2.) Brief on current status of Section 116, developed by Dave Spevacek in LRD.

STATEMENT OF ADMINISTRATION POLICY

May 16, 1983
(House)

H.R. 2915 - Department of State Authorization Act, Fiscal Years 1984 and 1985
(Reps. Fascell (D) Florida, Zablocki (D) Wisconsin and Gilman (R) New York)

The Administration supports House passage of H.R. 2915 and adoption of amendments to (1) delete Sec. 112, which would require the Director of the Office of Foreign Missions to be a Foreign Service Officer appointed by the President and confirmed by the Senate, (2) modify Title VI, the National Endowment for Democracy, to eliminate Constitutional questions concerning conflicts in that title with the Appointments Clause of Article II, Section 2, and (3) delete Sec. 116 which provides unnecessary authorities for the coordination of international communication and information issues.

* * * * *

(Not to be Distributed Outside Executive Office of the President)

While the Committee report is not available, we understand that H.R. 2915 authorizes fiscal year 1984 and 1985 appropriations for the Department of State, the United States Information Agency, the Board for International Broadcasting, the Inter-American Foundation and the Asia Foundation. As the table below notes, these respective authorization levels are very close to the Budget request.

($ in millions)	Administration Request		H.R. 2915	
	1984	1985	1984	1985
Department of State	2,451.5	2,582.4	2,456.2	2,592.4
U.S. Information Agency	711.4	871.0	701.4	861.0
Board for International Broadcasting	115.7	121.4	115.7	121.3
Inter-American Foundation	10.7	such sums	16.0	16.0
Total	3,289.3	3,574.8*	3,289.3	3,590.7

In addition to the problems referenced above, H.R. 2915 earmarks funds for a number of specific programs, contrary to longstanding policy. The Administration will seek to eliminate these earmarkings in conference.

This draft position was prepared by LRD in consultation with State (Alba), USIA (Dexheimer), NSC (Kimmitt), Justice (Perkins), BIB (Levin) and IAD (DuSault).

LR DRAFT
5/16/83

*Amount does not include IAF for FY 1985.

Section 116 of HR 2915, as orginally drafted established in State a position of coordinator of international telecommunication policy and placed responsibility for U.S. international telecommunication policy in that office. Commerce objected, believing other agencies had legitimate policy roles in the telecommunication area. After protracted negotiations State and Commerce agreed to a reworded Section 116 which established the office within State but vested it solely with reponsibility for coordinating State's various international telecommunication functions.

There has been no resolution of the larger interagency question which does not necessarily have to be resolved through legislation.

THE WHITE HOUSE

WASHINGTON

CABINET COUNCIL ON COMMERCE AND TRADE

October 3, 1983

3:00 P.M.

Roosevelt Room

AGENDA

1. Telephone Rate Legislation (CM#415)

(1) agree w/ FCC decis
(2) recog bill is moving
(3) Thus should wk w/ comm in shaping legis.

Baxter: proposes "cap" instead of moratorium

EM: get to Pres. tomorrow for decis.

= dear will make effort to get out of H (enough to sched bfre Nov holid for fl)
= out of S Comm Comm 15-2
[AT&T plans to commit major resources]

(1)

CABINET COUNCIL ON COMMERCE AND TRADE

October 3, 1983

PARTICIPANTS

The Vice President

Secretary Baldrige, Chairman Pro Tempore

Edwin Meese III
Jack Svahn, Assistant to the President for Policy Development
Acting Secretary McMillan
(Representing Secretary Block)
Under Secretary Ford
(Representing Secretary Donovan)
Acting Deputy Secretary Burnley
(Representing Secretary Dole)
Deputy Director Wright
(Representing Director Stockman)
William Niskanen
(Representing Chairman Feldstein)

Lee Verstandig, Assistant to the President for Intergovernmental Affairs

Wendell Gunn, Executive Secretary
Lawrence Herbolsheimer, Associate Director, Office of Cabinet Affairs

For Presentation:

David Markey, Assistant Secretary for Communications and Information, DOC
Ken Robinson, Policy Advisor to National Telecommunications and Information Agency, DOC

Additional Attendees:

Pam Bailey, Special Assistant to the President and Deputy Director of Public Affairs
Jim Cicconi, Special Assistant to the President and Special Assistant to the Chief of Staff
David Platt, Office of the Vice President

Manuel Johnson, Assistant Secretary of the Treasury for Economic Policy
William Baxter, Assistant Attorney General for Antitrust, DOJ

THE WHITE HOUSE
WASHINGTON

CABINET AFFAIRS STAFFING MEMORANDUM

DATE: 2-14-83 NUMBER: 118500CA DUE BY: ______

SUBJECT: Cabinet Council on Commerce and Trade - February 16, 1983
8:45 a.m. - Roosevelt Room

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

	ACTION	FYI
Baker	☑	☐
Deaver	☐	☐
Clark	☐	☑
Darman *(For WH Staffing)*	☑	☐
Harper	☑	☐
Jenkins	☐	☑
______	☐	☐
______	☐	☐
______	☐	☐
______	☐	☐
______	☐	☐
______	☐	☐
______	☐	☐
CCCT/Gunn	☑	☐
CCEA/Porter	☐	☐
CCFA/Boggs	☐	☐
CCHR/Carleson	☐	☐
CCLP/Uhlmann	☐	☐
CCMA/Bledsoe	☐	☐
CCNRE/Boggs	☐	☐

REMARKS: The Cabinet Council on Commerce and Trade will meet Wednesday, February 16, 1983 at 8:45 a.m. in the Roosevelt Room. The agenda and background papers are attached.

RETURN TO:

☐ Craig L. Fuller
Assistant to the President
for Cabinet Affairs
456-2823

☑ Becky Norton Dunlop
Director, Office of
Cabinet Affairs
456-2800

THE WHITE HOUSE

WASHINGTON

February 14, 1983

MEMORANDUM FOR MEMBERS OF THE CABINET COUNCIL ON COMMERCE AND TRADE

FROM: WENDELL GUNN
Executive Secretary

SUBJECT: Agenda for Meeting of February 16, 1983
8:45 am, Roosevelt Room

Attached are reading materials for this Wednesday's CCCT meeting. The items to be discussed are as follows:

1. DISC Replacement Proposal
2. FCC Synidication: The Financial Interest Rule

There is a possibility that the FCC syndication issue will be moved to the agenda of a Cabinet meeting with the President, to be held later on Wednesday or on Thursday. You will be notified when a final determination has been made.

Brock has 3 wks to present ait
[illegible] GATT meet [illegible] on [illegible].
[illegible] suppt [illegible]

THE SECRETARY OF COMMERCE
Washington, D.C. 20230

February 11, 1983

Memorandum for: Members, Cabinet Council on Commerce and Trade

From: MB Malcolm Baldrige
Chairman Pro Tempore

Subject: FCC Syndication and Financial Interest Rule

THE RULE

In 1970, the Federal Communications Commission (FCC) adopted its Syndication and Financial Interest Rule 1/ prohibiting the three major television networks (ABC, CBS, and NBC) from engaging in television program syndication and/or acquiring any financial interest in television programs produced by another entity (i.e., they are prohibited from producing programs for broadcast in which they are not the sole owner).

In July 1982, the FCC issued a Notice of Proposed Rule Making 2/ to review the impact of this Rule in light of changes in market conditions and evaluate the conclusions and recommendations made by the Network Inquiry Special Staff described below.

THE NETWORK INQUIRY

In January 1977, the FCC issued a Notice of Inquiry 3/ which sought information concerning the effects of its rules and whether less regulation was called for. The Commission epaneled a special staff which presented its conclusions and recommendations to the Commission in fall 1980. Without adopting or rejecting them, the Commission terminated the inquiry.

The Network Inquiry Special Staff concluded that the Rule was "misguided at best" and had "done little to further the Commission's goals of diversity or increased competition in the

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1/ 47 CFR §73.658 (j). See generally Viacom International v. FCC, 672 F.2d 1034, (2d Cir. 1982).

2/ Amendment of 47 CFR §73.658(j); the Syndication and Financial Interest Rule, BC Docket No. 82-345 ("Notice") (1982) .

3/ Commercial Television Network Practices, Docket No. 21049, 62 FCC 2d 548 (1977).

program supply market."4/ The report stated that the Rule failed to increase competition in the syndication market because the market was competitively structured prior to its imposition.

Specifically, the Network Inquiry Special Staff concluded: (1) the program supply market for prime time television was not concentrated prior to the Rule 5/; (2) the program supply market is competively structured today 6/; (3) the syndication market was competitive prior to the Rule 7/; (4) the syndication market remains competitive today 8/; (5) the Rule has resulted in inefficient risksharing by prohibiting network participation 9/; and (6) the Rule may have the unintended effect of handicapping the networks' ability to compete with new technologies. 10/

NETWORK ANTITRUST CONSENT DECREES

In 1972, the Department of Justice filed antitrust complaints against the three television networks charging violations of Sections 1 and 2 of the Sherman Act. The suits were dismissed without prejudice on procedural grounds 11/ but refiled in late 1974 12/ charging that: (1) ownership and control of prime time programming was concentrated among the networks; (2) the networks unreasonably restrained competition in the production,

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4/ Federal Communications Commission Network Inquiry Special Staff, New Television Networks: Entry, Jurisdiction, Ownership and Regulation ("New Television Networks") Vol. I at 510 (1980).

5/ Federal Communications Commission Network Inquiry Special Staff, Background Report, "An Analysis of Television Program Production, Acquisition and Distribution," (hereinafter "Special Staff Analysis") in New Television Networks, Vol. II, 293 at 556.

6/ Id. at 561.

7/ Id. at 532.

8/ Id. at 566.

9/ Id. at 622.

10/ New Television Networks at 518.

11/ United States v. National Broadcasting Co., 65 F.D.R. 415 (C.D. Cal. 1974).

12/ United States v. National Broadcasting Co., Civ. No. 74-3601-RJK (C.D. Cal., 1974); United States v. CBS, Inc., Civ. No. 74-3599-RJK (C.D. Cal., 1974); and United States v. American Broadcasting Companies, Inc., Civ. No. 74-3600-RJK (C.D. Cal., 1974).

distribution, and sale of entertainment programming; (3) program supply to the networks was unreasonably restrained; and (4) the public had been deprived of the benefits of free and open competition in the broadcast of television entertainment programming.

In late 1976, NBC and the Department of Justice filed a stipulation providing for the entry of a consent decree to settle the litigation. A little more than one year later, a modified version of the proposed consent decree was entered by the district court. 13/ Slightly more than two years after that, in mid-1980, first CBS, then ABC followed by entering into similar consent decrees with the Department of Justice. 14/

The consent decrees incorporate the major provisions of the Commission's Syndication and Financial Rule, and thus also restrict network program production and distribution. In addition, the consent decrees provide for further limitations on network program acquisition activities not addressed by the Commission's Rule. Thus, with very detailed provisions, the decrees govern and limit the timing and terms of network-program supplier agreements concerning program production, distribution, options, and exclusivity. For example, the ABC consent decree limits to four years the length of time the network can initially negotiate for exclusivity to keep a program out of daily (stripped) syndication. 15/ Thus, as the Commission noted in its Notice, "in all significant respects, the requirements of the consent decrees are more restrictive than or equivalent to the restrictions of our syndication and financial interest rule." 16/

Although the consent decrees incorporate the major provisions of the Commission's Syndication and Financial Rule, they are neither identical to the Rule nor should they be thought of as such. Although the two sets of limitations on network activities have much in common, they are separable and are not directly affected by the Commission's proceeding.

13/ United States v. National Broadcasting Co., 449 F. Supp. 1127 (C.D. Cal. 1978), aff'd mem., No. 77-3381 (9th Cir. April 12, 1978), cert. denied sub nom, CBS v. U.S. District Court for Central Division of Calif., 48 U.S.L.W. 3186 (1979).

14/ United States v. CBS, Inc., Civ. No. 74-3599-RJK (C.D. Cal. July 31, 1980), reprinted in 45 Fed. Reg. 34,463, 34,466 (1980); United States v. ABC, Inc., Civ. No. 74-3600-RJK (C.D. Cal.) reprinted in 45 Fed. Reg. 58,441 (1980).

15/ United States v. American Broadcasting Companies, Inc., supra, 45 Fed. Reg. at 58,443.

16/ Notice at ¶26.

MAJOR ISSUES

In its Notice, the Commission asked for comments on a number of specific matters most of which can be grouped into four major issues for the purpose of discussion and analysis: (1) Risk/Reward Sharing; (2) Network Ability to Compete with New Technology; (3) Producer versus Network Control; and (4) Program Warehousing. In addition, the Commission inquired about the appropriateness of its involvement in this area. The four major issues can be viewed as falling into two basic categories: the first three address the networks' ability to act as monopsonists (the ability to exercise market power as a buyer) in their relationships with program suppliers, and the fourth addresses the networks' potential to act as monopolists in the distribution of syndicated programming.

Appropriateness of Commission Action

One of the most important issues surrounding the Rule is whether it is appropriate for the Commission to regulate the private contractual relationships between producers and the networks. Those who argue that the Rule is necessary claim that the networks have an unfair advantage in their bargaining with producers. Proponents of repeal, however, argue that the relationship between producers and networks are really quite equal and therefore it is inappropriate for the Commission to regulate these private negotiations.

The Department of Commerce has taken the position that there are several reasons why the Commission should question the appropriateness of the Rule. First, allocative issues such as the redistribution of revenues and profits from the networks to program suppliers should not be a concern of the Commission. Second, and related to this first concern, it is inappropriate for the Commission to be concerned with success or failure of individual firms in a market as long as the overall market remains competitive. Finally, if, as has been alleged, the issue is not one of allocation, but rather protection against anticompetitive conduct as a result of network market power, then antitrust enforcement by the Department of Justice is the appropriate remedy.

A primary intent, and result, of the Rule is redistribution of profits from the networks to the major Hollywood producers. 17/ This, however, is an inappropriate topic for Commission concern.

17/ Amendment of Part 73 of the Commission's Rules and Regulations with Respect to Competitiveness and Responsibility in Network Television Broadcasting, Report and Order 23 FCC 2d 382, 399 (1970) (hereinafter "Report and Order"); see also discussion in Special Staff Analysis at 725-31.

It is widely agreed by producers and network representatives alike that the Commission should not be concerned with the division of revenues or profits in a healthy competitive market. Nor should the Commission be concerned with the success or failure of any individual firm as long as the overall market remains competitive. There is an understandable difference of opinion, however, as to what exactly constitutes an allocative issue.

Even if the Special Staff was wrong and the networks could distort the market by exercising market power, the Department of Commerce believes that it is the Antitrust Division of the Department of Justice and not the Commission that should be responsible for enforcing the nation's antitrust laws. Unless a compelling case can be made to the contrary, to the extent that protection against anticompetitive behavior and undue market power is required, sufficient remedies rest with the Department of Justice and private antitrust litigants exercising their rights under existing law. To the extent that the Rule is concerned with allocating revenues and profits among firms and industry segments, it is an inappropriate activity of a government agency.

In its comments to the FCC on the Rule, however, the Department of Justice Antitrust Division states:

> Opponents of the rules have argued that, even if such network collusion is possible, the antitrust laws would effectively forestall it. The antitrust laws, of course can effectively attack overtly anticompetitive actions [citing Unites States v. NAB, 536 F. Supp. 149 (D.D.C. 1982)]. It is unclear, however, how likely detection and effective prosecution would be under the Sherman Act in cases of tacit collusion without explicit agreement. The networks have engaged in many parallel practices, including the number of reruns aired, the number of commercial minutes run on network programs, and the production fees paid for programming. It is difficult to ascertain whether these practices are the result of vigorous competition by the networks or of tacit collusion that has reduced competition. The costs of litigation to determine whether parallel network conduct regarding release of off-network syndicated programming [is unlawful (?)] would be substantial. Thus, the Department is not confident that the antitrust laws can be relied upon as the most effective tool for ensuring against possible anticompetitive network practices in this area. 18/

18/ "Comments of the U.S. Department of Justice in FCC BC Docket No. 82-345 (filed January 26, 1983) at pp. 40-41.

Risk/Reward Sharing

The networks argue that since they assume the primary financial risk for developing new television series they should be permitted to share in any profits at the "backend" (after network first run). They argue that the producers would have no product to sell in syndication if networks had not taken the risk, financed the pilot, chosen the program for prime time broadcast, and kept the program on the air for at least three to five years. The networks go on to argue that if they were permitted to have a financial interest in programming and/or to acquire syndication rights, they would be able to pay producers more than just a license fee at the time of production. In addition, the networks argue that preventing them from having a financial interest, or sharing the risk, works to the disadvantage of new entrants because it keeps them from financing small independent producers who otherwise would have no source of capital with which to produce their project.

The major producers (studios) reject the networks' arguments by pointing out that they, as the supposed beneficiaries of increased "frontend" payments in exchange for sharing "backend" profits, are not interested in increasing "frontend" payments. They state that they would rather have the networks pay less at the outset but be able to keep the syndication rights for themselves. They go on to state that if the networks are allowed to obtain partial financial interest and syndication rights that producers will have no choice but to agree to network demands for such rights since the networks are monopsonists.

In addition, producers claim that the networks now are able to "share in the profits" from a successful program by virtue of the significant advertising revenue generated from selling time during and adjacent to prime time programs. In addition, producers claim that the networks are even able to recoup their investment in pilot programs not developed into series by airing them in the summer and offsetting some of their investment with advertising revenues such programs generate. Because of this revenue, the studios claim that the networks are not taking the bulk of the risk when financing a new series but, rather, are merely end users of a product.

This view ignores the significant investment that each network makes in new programming annually as well as the enormous uncertainty of success in the process. As an example, for the four seasons from 1978-1982, CBS commissioned a total of 805 scripts of which 160 were made into pilots and only 51 became series. Only 12 of these, less than 1.5 percent of the original scripts, were successful enough to be renewed for at least one season. Contrary to the producers' assertions, the networks make a significant investment in programming and take a substantial risk in program development. It is also questionable to assert that the networks cover all their investment in program development by airing or "burning off" pilots and failed series during the summer. Shortly after Grant Tinker became president of NBC, that network wrote off approximately $38 million in programming that could not be used. Likewise, for 1981, ABC wrote off approximately $29 million in direct program development costs that could not be recouped (e.g., through summer broadcast). It should be noted that these costs reflect gross figures and do not include provisions for overhead or lost opportunities resulting from preemption of other (more popular) programs. To say that the networks do not take significant risks in the program development process is not accurate. To prohibit them from sharing in the potential rewards not only is unfair, but also threatens their future ability to compete effectively with unregulated competitors (e.g., cable and pay networks) for new programming.

Network Ability to Compete with New Technology

The networks claim that they are at a disadvantage competing with new delivery systems such as cable television (HBO is the example often used), MDS, DBS, and STV for program rights. They argue that since these delivery systems can also participate in program production by obtaining a minority financial interest and syndication rights which provide backend profits, they can outbid the networks for product. The networks want the ability to obtain a financial interest, including syndication, in order to "level" the bargaining table. The networks state that they need to "amortize" product over several distribution media in order to pay for increasingly expensive programming. The networks point to theatrical films and some sports as examples of programming for which they can no longer successfully bid against cable and STV. Therefore, they argue that the rule is skewing the development of the new media by giving them an unfair bidding advantage against the networks. Further, the networks point to the drop in network audience share as evidence of their claim that the new media are succeeding in the marketplace.

Those in favor of retaining the rule disagree that the rule prevents the networks from competing with the new media. They point to the FCC's 1981 Declaratory Ruling allowing CBS to acquire nonbroadcast rights to television programs, for the now failed CBS Cable; CBS's proposed MDS venture with Contemporary Communications, Inc. and its recently announced joint venture with HBO and Columbia Pictures to build a movie studio; and, ABC's multiple nonbroadcast projects with Hearst, ESPN, Sony, and Group W Cable.19/ The only activity the networks are restrained from, they point out, is broadcast television program syndication.

19/ Declaratory Ruling on Section 73.658(j)(1)(ii), 87 F.C.C. 2d 30 (1981), aff'd sub nom. Viacom International, Inc. v. FCC, 672 F.2d 1034 (2nd Cir. 1982).

The problems for the networks, however, are not insignificant. Although it has been predicted that, because of growth in the general population and number of households, the networks' audience in terms of households and viewers will remain relatively constant and will not decline along with their shares, it also is predicted that network costs for programming will increase significantly. Without the increases in audiences they have enjoyed over the past thirty years, the networks may find it increasingly difficult to compete successfully for new programming. The networks' inability to share in syndication and other subsidiary rights because of the Rule has therefore become more than just an inconvenience. In order to pay the high prices prime time programming demands, the networks need to be able to share in the non-network revenues generated through exploitation of subsidiary rights. The only alternatives are either to raise advertising rates or purchase less expensive programming. Given the increasingly competitive nature of the advertising business, it is unlikely that the networks would be able to raise their rates sufficiently to cover their increasing program costs. An undesirable alternative would be to increase the number of minutes devoted to advertising each hour. This would likely be counter-productive since advertisers would resist increased "clutter" and viewers would have additional incentive to desert the networks for advertising-free subscription services. Nor is purchasing less expensive programs a viable solution. It is difficult to envision producers being able or willing to provide the kinds of network prime time drama and comedy that comprise the bulk of the networks' schedules for very much less than they now charge. It has been suggested that, in order to cut costs, the networks may have to begin scheduling game shows and other low budget programs in prime time. One potential outcome of Rule retention, therefore, is that the producers objecting to repeal might find themselves without customers for the very programming they argue needs protection. Not only would the networks and producers suffer from such cutbacks, but so too would the independent stations that depend on expensive off-network programming for much of their schedule. The ultimate loser, of course, would be the public.

<u>Producer Versus Network Control</u>

Program producers (both studio and independent) claim that if the networks are permitted to obtain a financial interest in programming and re-enter the syndication business, producers will be at a critical disadvantage in bargaining and negotiating with the networks. First, they claim they would be unable to resist network demands for financial participation and syndication rights. Second, and more important for some, producers fear losing creative control of their programs if the networks regain a financial interest.

Experience does not support these fears. Prior to adoption of the Rule, the networks did not obtain a financial interest in all programs. While they commonly obtained syndication rights from producers who did not operate their own syndication business, this was not typically the case with programs produced by the major studios or other producers operating their own syndication business. Further, independents not desiring to negotiate directly with the networks could always enter into an "umbrella" agreement with a studio, much as they do today.

Regarding fears about creative control, with or without a financial interest in a program, the networks already have ultimate or final control over the nature of the programs they purchase for broadcast. Indeed, as a licensee (each with five owned and operated stations) with a responsibility to its affiliates, each network properly oversees the content of each program it broadcasts. It is in the mutual interest of networks and program suppliers to have successful programs. Disagreements about how to achieve that commercial success exist today and inevitably are part of the television program development and production process. It would be unfair, however, to characterize the network-producer relationship as an adversarial one in which all producers are in conflict with all three networks. To the contrary, most producer-network relationships are mutually beneficial. Repeal of the Financial Interest and Syndication Rule will not significantly alter these relationships.

The Commission has inquired about the imbalance in bargaining power between producers and the networks. Most producers as well as network representatives agree that while there may be an imbalance in favor of the network in initial negotiations, once a program qualifies as a "hit" (i.e., the network wants to renew it), the advantage shifts to the producer. Indeed, the Network Inquiry Special Staff found, that among the network-producer contracts that they examined, all had been amended for series appearing on the network for more than three years.20/ Therefore, to assert that the relationship between a network and a producer is one-way and imbalanced is to ignore industry practice. If the fear on the part of producers is that they will be forced into unfavorable contracts with the networks, they do not adequately recognize the shift in bargaining power that occurs when a program is successful enough to be renewed.

While the question of program control is an important one for producers, it is not addressed by the Rule in question. The networks today, with the Rule in place, appropriately control the programs they license and broadcast. Repeal of the Rule will not change the fundamental buyer-seller relationship between network and producer in which the networks have the ultimate control of choosing to broadcast or not to broadcast a particular program.

20/ Special Staff Analysis at 463.

Program Warehousing

The most difficult issue raised by proposals to repeal the Rule is whether independent television stations require special protection from potential network "warehousing" of programming. While the three preceding issues appear to be allocative and therefore outside proper government action, this issue potentially involves important competitive issues. However, as discussed below, there is little reason to believe that the potential for warehousing is a real threat and, more importantly, if it were to become a problem, the proper remedy lies more appropriately through antitrust enforcement by the Department of Justice rather than by Commission rule.

Independent television stations fear that if the networks are permitted to obtain syndication rights for network series and re-enter the syndication business, there will be a "conflict of interest" where the networks will control sale and use of programs used to compete with their network affiliate and O & O schedules. The independents claim that the networks would withhold popular programs from syndication in order to limit this competition. This claim goes on to argue that the result would be a lessening of competition in the program syndication business, weaker independent stations, and, therefore, higher overall advertising costs. There is little empirical support, however, for these claims, all of which hinge on the desire and ability of the networks to withhold programming.

Independent distributors also fear network reentry into syndication claiming that if the networks are able to obtain syndication rights at the time of initial negotiations for network first run, independent distributors will not have a chance to bid on such rights. They claim, therefore, that the syndication business would become more concentrated.

This alleged potential for withholding is based upon three questionable assumptions about network activity that, while theoretically possible, do not reflect the reality of sound business practice. First, the withholding argument is premised on the networks' ability to control virtually all off-network programming. In order to accomplish this, the networks would either have to buy syndication rights for all programs they develop or, since this would be prohibitively expensive, buy syndication rights only for those series that become hits. The problem with this assumption is that no one can predict which programs will be successful. One only has to look at the extremely high failure rate of program development to see the difficulty involved. The notion that the networks could control even a majority of syndicated programming is thus totally at odds with the state of the industry. The program syndication market is competitively structured and was so before the networks were restricted by the Rule.

The second questionable assumption underlying the alleged withholding threat is that the three networks will collusively form an undetected cartel to coordinate their syndication activities. Given the highly competitive nature of the television programming and syndication businesses, such coordinated action, or its potential success, is highly improbable. Not only would the networks have to avoid Justice Department detection and enforcement, they would have to avoid detection by potential private litigants. The latter problem would be particularly acute since the television distribution industry is extremely fluid with personnel moving among firms and industry segments many times during a career. Finally, the most difficult task for the cartel would be to enforce its agreements since the incentives to violate the agreement would be extremely high, given the assumed demand for scarce off-network programming. Those who argue that the networks would not have to act collusively, but only in parallel, fail to recognize the significant incentives to enter the syndication business, especially if there is a shortage of product.

The third questionable assumption is that the networks will engage in irrational business practices. That is, they would purchase, at considerable expense, program syndication rights and then choose not to exercise those rights. A primary reason the networks desire to reenter the syndication business, however, is to be able to share in the rewards associated with a successful television series by participating in syndication revenues. For the networks to "sit" on these rights, failing to exploit them, would be acting against their own and their stockholders' best interests. Further, since the networks would rarely be the sole owner of a program, they would open themselves up to lawsuits from partners if they were to act contrary to their partners' (and their own) interests. To argue that the networks would pay for rights they would not use is to ignore the fiscal necessities of the highly competitive television entertainment business.

Because of the highly unlikely event that the networks would have the desire or the ability to withhold programming, it is not even necessary to address claims that independent station viability would be harmed and therefore advertising rates would increase if the networks were permitted to engage in program syndication. It should be noted, however, that even if a convincing showing can be made that independent station strength is related to local market spot advertising rates, linking station health and advertising rates to any particular program or program type is a separate issue.

CONCLUSION

Although producer fears about repeal of the Commission's Financial Interest and Syndication Rule are genuine, they do not appear to be justified. Although some independent producers may find it difficult to remain "independent" (i.e., outside an "umbrella" arrangement with either a major studio or a network), it is unlikely that the business of producing television programs, especially prime time series, will become any more concentrated. Although it is likely, as was the case before the Rule, that the networks will be able to obtain syndication rights from independent producers, there is no evidence such arrangements will do anything but shift a portion of the syndication business from the studios to the networks. However, if producers would rather work with the studios, there would be nothing preventing them from doing so through an "umbrella" arrangement giving the studios syndication rights.

Producer concerns about "creative control" are understandable but again unsupported. The networks already have significant control over program content and if producers fear network intrusion they will always be able to seek "insulation" by working through the studios as they do now.

Likewise, if individual program distributors fail because of the entry of more efficient competitors, this will not result in significant increases in concentration and, in any event,should not be the concern of an independent regulatory agency. If, on the other hand, business failure is the result of anticompetitive behavior and undue market power, then there are sufficient existing antitrust remedies available to the Department of Justice and private litigants.

Based upon available evidence, the only issue raised that may be more than allocative is the impact of eliminating or modifying the Rule on the availability of programming to independent television stations. If eliminating the Rule resulted in withholding popular off-network syndicated programs from syndication, then questions would have to be raised about network behavior. However, such an outcome is unlikely. And if the networks were able to create an effective cartel, they certainly would find themselves subject to Department of Justice and private antitrust litigant scrutiny and action.

The ability of the networks to withhold programming from the syndication market is based on three seemingly implausible assumptions: (1) networks would be able to control the vast majority of "important" programs in syndication; (2) networks would be able to maintain the cartel and avoid detection; and (3) networks would act irrationally and not exploit a valuable property.

Summarizing, the Commission's Financial Interest and Syndication Rule never achieved its intended effect of increasing both the number of producers and the amount of programming available for both network broadcast and syndication. Both program supply and program syndication markets are competitively structured today and were so before the Rule was promulgated. Overall, therefore, the Rule appears to have had little impact on the program market other than skewing market shares in the direction of producers, and permitting entry by some new firms. Repeal, however, would havethe positive effect of promoting competition in program supply by permitting independent producers to work directly with the networks if they so desire. Repeal also would permit increased competition in program distribution by permitting three additional entities (i.e., the networks) to compete.

Perhaps most importantly, to the extent that the Rule is concerned with allocating revenues and profits among firms and industry segments, it is an inappropriate activity of a government agency. In addition, to the extent that protection against anticompetitive behavior and undue market power is required, sufficient remedies rest with the Department of Justice and private antitrust litigants exercising their rights under existing law.

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PROPOSAL FOR A DISC REPLACEMENT

Introduction

At its December meeting, the Cabinet Council on Commerce and Trade requested the Treasury Department, in conjunction with the Office of the United States Trade Representative (USTR) and the Department of Commerce, to develop a tax alternative to the Domestic International Sales Corporation (DISC) that would be both legal under the General Agreement on Tariffs and Trade (GATT) and revenue neutral. This paper describes a proposal that has been discussed by these agencies with general agreement on its structure, but no final agency approvals.

A territorial tax system is acceptable under GATT. This means that a country is not required to impose tax on income from economic activities or processes occurring outside its borders. The GATT acceptability of a territorial system is qualified by the requirement that arm's-length pricing rules be used to allocate profits between related domestic and foreign economic entities. In light of these rules, the United States would not be conveying an illegal export subsidy if it exempted from U.S. tax export sales income, measured on an arm's-length basis, and related to economic activity occurring outside the United States.

The principles of arm's-length pricing and the location of economic activity also are important features of U.S. tax law. These principles are essential to insuring that U.S. law is effectively enforced, that U.S. taxpayers pay their fair share, and that the U.S. Treasury does not lose tax revenue through abusive and artificial profit shifting. Accordingly, the following proposal conforms not only with the relevant GATT principles, but the requirements for the transfer pricing safe harbor are based upon the same types of factors used in U.S. tax law. Furthermore, the proposal minimizes the dislocation of economic activity offshore in a way that is consistent with adherence to these principles under U.S. tax law.

Summary of Proposal

This proposal exempts from U.S. tax a portion of a foreign corporation's export sales income. If a U.S. manufacturer forms a foreign corporation for the purpose of making export sales, a portion of the foreign corporation's income will be exempt from U.S. tax at both the corporate and shareholder levels. To satisfy the GATT requirement that the tax exempt income be from "economic processes located outside the country," certain significant sales functions will have to be performed outside the United States by or for the foreign corporation.

The income earned by the foreign corporation will be determined under arm's-length transfer pricing principles. A safe harbor transfer pricing rule will be available for determining an arm's-length profit allocation and will insure that 19 percent of the combined taxable income earned by the U.S. manufacturer and foreign corporation will be exempt from U.S. tax. Alternatively, the income of the foreign corporation can be determined under the arm's-length transfer prices allowed by the current regulations under section 482 of the Internal Revenue Code (Code).

This proposed amendment to the Internal Revenue Code will allow U.S. producers and manufacturers to sell goods to foreign purchasers under tax rules which are comparable to the rules which existed prior to the enactment in 1962 of the subpart F provisions of the Code.

While the current DISC provisions will be repealed, the prospective tax on the accumulated tax-deferred income of a DISC will either be forgiven, or the deferred income and potential tax liability will be transferred from the DISC to the new foreign sales entity.

Because the asset limitations of the existing DISC provisions add great complexity and reduce the effectiveness of the DISC, these requirements are not included in this proposal.

Basic Elements of the Proposal

U.S. taxation of FTI earned by the foreign corporation. A foreign export sales corporation will be exempt from U.S. tax on a portion of its foreign trading company income (FTI). If the seven activities described below are performed by the foreign corporation, or for it on a contract basis, in connection with the foreign trading corporation's gross receipts, then the foreign corporation will not be subject to U.S. tax on a portion of the FTI (generally 19 percent of the combined taxable income earned by the manufacturer and foreign corporation) attributable to such receipts, regardless of whether the foreign corporation maintains a U.S. office or contracts for other services to be performed on its behalf in the United States.

Foreign trading company income. FTI will be defined to mean income (whether in the form of profits or commissions) derived in connection with foreign trading gross receipts. Foreign trading gross receipts are gross receipts from:

(a) the sale, exchange, or other disposition of export property;

(b) the lease or rental of export property which is used by the lessee outside the United States;

(c) the performance of services which are related and subsidiary to the sale, exchange, lease, rental, or other disposition of export property by the foreign corporation;

(d) the performance of engineering or architectural services for construction projects located outside the United States; and

(e) the performance of managerial services in furtherance of the production of foreign export trading gross receipts.

"Export property" generally means property manufactured, produced, grown, or extracted in the United States for direct use, consumption, or disposition outside the United States.

Transfer pricing rules. The price at which export property is transferred from the U.S. manufacturer to the foreign sales corporation will be determined using arm's-length transfer pricing principles. In a departure from the provisions in the current section 482 regulations applicable to sales of goods and services, the proposal provides a safe harbor approximation of the arm's-length price. The safe harbor allocation will be equal to 19 percent of the combined taxable income earned by the manufacturer and the foreign corporation. To justify this safe harbor in light of U.S. tax law requirements, the seven activities described below will have to be performed by or for the foreign corporation. As an alternative to the safe harbor, taxpayers may determine the allocation of income by transferring export property to the foreign corporation on the basis of an arm's-length price determined under section 482. Regardless of which transfer pricing rule is chosen, to satisfy the GATT requirement that economic processes occur outside the country, some or all of the seven activities must be performed, in part or in total, outside the United States by or for the foreign corporation. For this purpose, the U.S. territories of Guam, the Virgin Islands, and the Northern Mariana Islands will be considered outside the United States.

Conditions for transfer pricing safe harbor and exemption from U.S. tax. To be eligible either for the 19 percent safe harbor transfer pricing rule or the exemption from U.S. tax, the foreign corporation will be required to:

1. Maintain an office outside the United States.

2. Maintain books and records in that foreign office. (For purposes of U.S. tax administration and enforce-

ment, it may be necessary for the books and records to be available for examination in the United States).

3. Have at least one resident director in the foreign office.

The following also must occur outside the United States.

4. (a) If the income earned is sales income, taking title to the goods; or

(b) if the income earned is commission income, holding a non-exclusive distribution license with respect to the product.

In addition, some or all of the following economic functions must be performed, in part or in total, outside the United States by the foreign corporation, or for it on a contract basis, in connection with foreign trading gross receipts:

5. Soliciting orders from and negotiating contracts with customers.

6. Processing customer orders.

7. Billing customers and receiving payment.

The necessity for some or all of activities 5 through 7 to be performed, in part or in total, outside the United States is to comply with the GATT's "economic processes" requirement. The exact requirements present an important issue that must be decided. If, however, U.S. exporters, as part of their normal business practices, perform other significant activities outside the United States, consideration will be given to substituting those for some of the criteria listed in items 5 through 7.

Taxation of U.S. shareholders of foreign corporation. The tax exempt portion of FTI will not be included in the income of a U.S. shareholder under subpart F. In addition, U.S. shareholders will be allowed a 100 percent dividends received deduction with respect to actual dividends from earnings attributable to tax exempt FTI. The dividends received deduction will be in lieu of a foreign tax credit. Other earnings will remain subject to the existing U.S. tax regimen, including the subpart F and foreign tax credit rules.

Revenue neutral cap on the tax exempt benefit. The CCCT specified that the proposed alternative should cost no more than the DISC. For taxpayers using the safe harbor, the amount of tax exempt FTI will be limited to 19 percent of the combined taxable income of the foreign corporation and a related supplier from foreign trading gross receipts. If the foreign corporation purchases goods from an unrelated party or determines its transfer prices under the section 482 regulations, the limit on the tax exempt benefit will be equal to 32 percent of the foreign corporation's FTI.

Simplification. Under the proposal, the tax benefit conferred on FTI is exemption from U.S. tax. The proposal therefore eliminates conditions on the tax benefit such as requirements that tax deferred income be invested in certain assets. The tax exempt funds can be made immediately available to U.S. shareholders of the foreign corporation tax free, without the necessity of complicated producer's loan type limitations.

The elimination of asset requirements also avoids the problems presently associated with accumulated DISC income. Complicated "recapture" provisions for accumulated FTI will be unnecessary. The simplification of the measure will to some extent offset the burden of conducting activity outside of the United States.

Small business exception. Although this proposal is simpler than DISC in that the qualified export assets and incremental provisions are deleted, the need for establishing a foreign corporation may concern certain small exporters. It may be possible to increase the attractiveness of the proposal by carefully educating small exporters as to its appeal, but some special provision for small business must be included. Such a provision could involve:

- Encouraging use of the recently-passed Export Trading Company legislation. It may, for example, be possible for a group of small exporters to form and use a single foreign sales corporation on a shared basis.

- Small exporters could be allowed to keep their DISCs, but required to pay an interest charge on the value of the tax deferral. By eliminating the incremental provisions and qualified assets tests and by increasing the deferral and using simple, rather than compound, interest at the section 483 rate, the benefits of the current DISC could be approximated.

- A more controversial alternative would leave DISC unchanged for small exporters, but require the United States to be prepared to pay compensation to its trading partners.