Domestic International Sales Corporations--A Tax Incentive for Exporters

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Note: Domestic International Sales Corporations—A Tax Incentive for Exporters

I. INTRODUCTION

Over the past decade the United States balance of payments situation has been steadily worsening, in large part as a result of
the continuing diminution in the nation's foreign trade surplus.\(^1\) In 1970, the Treasury Department proposed legislation to permit formation of tax-favored entities known as Domestic International Sales Corporations (DISCs) which would function solely to handle foreign sales of domestic production. The proposal was designed to promote the export of domestically produced goods, thereby helping to reverse the unfavorable balance of payments trend.\(^2\) In addition, by offsetting the tax advantages realized when manufacturing facilities are located overseas, the Treasury Department hoped to encourage manufacturers to locate their plants in the United States.\(^3\) The DISC proposal was enacted into law as part of the Revenue Act of 1971, but only after Congress reduced the proposed benefits by roughly 50\%.\(^4\)

The statute is essentially a tax deferral provision which establishes a tax exempt domestic corporation, the DISC, whose earnings are passed through to its shareholders. Approximately 50% of a DISC's income is taxed annually to the shareholders regardless of whether it is distributed. The tax on the balance is deferred until the earnings are actually distributed or until DISC status is terminated. Special intercompany pricing rules permit the DISC to acquire inventory from related suppliers at less

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1. The heart of our present balance of payments problem lies in the fact that, largely under the pressure of internal inflation and overheating, our traditional trade surplus has dwindled away. *Hearings on Tariff and Trade Proposals before the House Comm. on Ways and Means, 91st Cong., 2d Sess., pt. 2, at 500 (1970) (statement of David M. Kennedy, Secretary of the Treasury)* [hereinafter cited as 1970 *Hearings*].

2. We no longer have a surplus in the balance of goods and services. Instead of surpluses ranging from $7.1 billion in 1965, $2 billion in 1969 and $3.6 billion in 1970, we have a deficit of $88 million in the second quarter of [1971]. *S. REP. No. 92-437, 92d Cong., 1st Sess., at 108 (1971)*.


than arms length prices, which results in the allocation of a greater share of the overall profit on an export sale to the tax-favored DISC. Also, a DISC is permitted to utilize its tax deferred earnings by making "producer's loans" to domestic producers, including affiliates, provided the borrower uses the proceeds to increase its export production capability. The 50% tax deferral and the intercompany pricing rules combine to reduce the parent corporation's effective current rate of U.S. tax from 48% to between 24% and 36% on an export transaction handled exclusively by a DISC, and even lower if foreign subsidiaries are also used.

This note will survey the general mechanics of the DISC statute and will analyze in detail those provisions which appear to be areas of potential dispute. It also will examine the impact of the DISC from the standpoint of a domestic producer who relies exclusively on the DISC to manage foreign sales as well as the producer who integrates the DISC into a corporate structure which includes foreign subsidiary corporations. The reader is cautioned that this note was prepared primarily with reference to the statute and the committee reports. Treasury regulations have not yet been issued and may be expected both to clarify and to conflict with points raised in the subsequent discussion.⁵

II. LEGISLATIVE HISTORY⁶

The DISC provision passed through three distinct phases before becoming law. The original Treasury Department proposal

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⁵ This note will not attempt an economic analysis of the wisdom of using tax incentives to promote exports. However, some of the arguments of both proponents and opponents are discussed in note 8 infra.


was adopted by the House of Representatives as part of the Trade Act of 1970, but that bill did not pass the Senate. Its most controversial feature was the complete tax deferral of DISC earnings.) The DISC was reintroduced and passed in a

Initially adopted, subsequent references, except as otherwise noted, will refer to S. Rep. No. 92-437, 92d Cong., 1st Sess. (1971) [hereinafter cited as COMMITTEE EXPLANATION].


8. See dissenting views of Representatives James C. Corman and Sam M. Gibbons, H.R. Rep. No. 91-1435, 91st Cong., 2d Sess., at 177-87 (1970); 1970 Hearings, supra note 1, at 2585-96 (1970) (statement of Professor Alan Schenk). Corman and Gibbons opposed the original DISC proposal on numerous grounds. They argued that: (1) it would create a new form of tax discrimination against corporations producing exclusively for the domestic market; (2) the proposal went beyond what was necessary to equalize the tax advantages of foreign subsidiaries; (3) the tax deferral in effect could have become an exemption since the DISC could loan its tax deferred income to its parent; (4) the anticipated increase in exports was not sufficiently large to warrant the concomitant loss of revenue; and (5) it appeared unlikely that the original proposal would have actually increased exports or provided sufficient incentive for manufacturers to locate their plants in the United States.

Professor Schenk adopted a somewhat different position. He contended that if the United States wished to equalize taxation of foreign and domestic subsidiaries it should extend its taxing jurisdiction over the foreign subsidiaries. The Treasury Department responded that this would further weaken the ability of American corporations to compete with foreign corporations which generally are subject to less stringent taxation. The Treasury Department predicted that such extension also would force American corporations to remit their foreign income in dividends to be certain of obtaining the foreign tax credit, thereby depriving the corporations of funds necessary to expand their foreign markets. 1970 Hearings, supra note 1, at 504-05 (statement of John S. Nolan, Acting Assistant Secretary (Tax Policy), U.S. Treasury Dep't).

Professor Schenk also argued that the original proposal would constitute a windfall to existing exporters since the deferral privilege extended to all export earnings rather than merely to future increases. He doubted that small manufacturers would be encouraged to begin exporting since they were likely to lose money for the first few years and DISC losses could not be passed through to the parent.

Representatives Corman and Gibbons agreed with Professor Schenk that the United States should extend its taxing jurisdiction over the foreign subsidiaries rather than allow further tax deferral as a means of achieving tax equality. They further agreed that the original DISC constituted a windfall to existing exporters. As an alternative, Corman and Gibbons suggested that the government "upgrade its export-expansion program and provided subsidized insurance and greater access to cheap credit with a minimum of redtape." H.R. Rep. No. 91-1435, 91st Cong., 2d Sess., at 166 (1970).

See also, Miller, Reform in Taxation of Foreign Source Income, 48 Taxes 342, 345 (1970), where Senator Miller of the Senate Finance Committee suggests:

Expansion of the Western Hemisphere Trade Corporation device to cover all foreign countries has been suggested by some au-
vised form by the House in 1971. This bill adopted an incremental approach which would have allowed a DISC in each year to defer taxation of all earnings in excess of 75% of its average income for the 1968-70 base period. The Senate made two important amendments to the bill which were accepted by the Conference Committee and enacted into law. The incremental approach, considered too complex, was abandoned in favor of a flat 50% tax deferral. The second Senate amendment terminates the tax deferred status of DISC earnings loaned to members of its controlled group to the extent that the group also is investing overseas.

While Congress may have adopted a somewhat ambivalent position on the value of encouraging exports through tax incentives over the past two decades, the DISC provision is unequivocally premised on the theory that such incentives will increase the amount of American goods sold abroad and thereby assist in remedying the current balance of payments situation. The Senate Finance Committee Report states:

9. H.R. 10947, 92d Cong., 1st Sess. (1971). The incremental approach of the 1971 House version would have substantially eliminated the windfall to existing exporters to which Professor Schenk had objected. See note 8 supra. The incremental approach previously had been considered and rejected by the Treasury Department because of the difficulty in establishing an equitable base period and because the DISC was designed to maintain existing exports as well as hopefully increasing them. 1970 Hearings, supra note 1, at 525 (remarks of John S. Nolan, Acting Assistant Secretary (Tax Policy), U.S. Treasury Dep't). Representative Gibbons again dissented, contending that his previous arguments had not been met. See note 8 supra. He did, however, commend the incremental approach of the revised bill as well as its refusal to allow excess foreign tax credits from other operations to be offset against DISC income. H.R. REP. No. 92-533, 92d Cong., 1st Sess., at 108 (1971).

10. See text following note 82 infra.

11. See text accompanying notes 89-90 infra.

12. Such incentives are contrary to the theory of capital export neutrality and they may not result in the most efficient allocation of world resources or in the maximization of world welfare. See P. Richman, TAXATION OF FOREIGN INVESTMENT INCOME: AN ECONOMIC ANALYSIS 5-36 (1963).

13. The Treasury Department has never contended that the DISC, even in its original proposed form, would be a complete solution to the balance of payments problem. This we hope will help stimulate corporate management to look harder at export markets and to look harder at them over a period of time and devote additional effort, time, and talent to those markets. But this is not a proposal which is suddenly
The committee agrees with the House that it is important to provide tax incentives for U.S. firms to increase their exports. This is important not only because of its stimulative effect but also to remove a present disadvantage of U.S. companies engaged in export activities through domestic corporations. In addition, other major trading nations encourage foreign trade by domestic producers in one form or another.

Congress quite clearly accepted Treasury Department arguments that the DISC provision will permit American firms to charge less for their products, that it will provide more incentive to search out and to develop foreign markets, and that it will permit them to spend a greater amount on export promotion.

III. QUALIFICATION REQUIREMENTS: ACHIEVING AND MAINTAINING DISC STATUS

To qualify as a DISC, a corporation must meet four requirements:

1. The corporation must be a domestic corporation

This estimate must be tempered not only by the fact that the final provision extended only half the tax advantage originally contemplated, but also, because of the reduction, fewer corporations are likely to utilize the DISC. The revenue loss under the original proposal was estimated at $610 million annually. Id. The revenue loss under the DISC as finally enacted is estimated at between $170 and $200 million annually. COMMITTEE EXPLANATION, supra note 6, at 17. The Treasury Department contends that the revenue loss will be offset by the secondary economic effects emanating from the DISC, such as increased export trade, increased gross national product, and increases in export-related jobs. Letter of Paul A. Volcker, supra.

14. COMMITTEE EXPLANATION, supra note 6, at 17.

15. 116 Cong. Rec. at H10527 (daily ed. Nov. 19, 1970) (Letter of Paul A. Volcker, Under Secretary for Monetary Affairs, U.S. Treasury Dep't). It was estimated that the DISC, as originally proposed, would increase the level of United States exports by more than $1 billion, and perhaps as much as $2 billion per year when in full operation. Id. This estimate must be tempered not only by the fact that the final provision extended only half the tax advantage originally contemplated, but also, because of the reduction, fewer corporations are likely to utilize the DISC. The revenue loss under the original proposal was estimated at $610 million annually. Id. The revenue loss under the DISC as finally enacted is estimated at between $170 and $200 million annually. COMMITTEE EXPLANATION, supra note 6, at 17. The Treasury Department contends that the revenue loss will be offset by the secondary economic effects emanating from the DISC, such as increased export trade, increased gross national product, and increases in export-related jobs. Letter of Paul A. Volcker, supra.


17. I.R.C. § 992(d) denies DISC status to certain types of corporations: (1) a tax exempt corporation (I.R.C. § 501); (2) a personal holding company (I.R.C. § 542); (3) financial institutions (I.R.C. §§ 581, 593); (4) insurance companies (I.R.C. §§ 801-44); (5) a regulated investment company (I.R.C. § 851(a)); (6) China Trade Act corporations (I.R.C. § 941(a)); and (7) electing small business corporations (I.R.C. § 1371(b)). In addition, a corporation is denied the
with only one class of stock of which at least $2,500 in par or stated value is outstanding;
(2) the shareholders must consent to the election of the corporation to be treated as a DISC;
(3) 95% of the corporation's gross receipts for each taxable year must consist of "qualified export receipts;" and
(4) 95% of the corporation's assets at the close of the taxable year must be "qualified export assets."

Upon qualification, the DISC is exempt from United States taxation at the corporate level for as long as it continues to satisfy the percentage tests. The tax avoided includes not only the corporate income tax, but also the minimum tax on tax preferences and the accumulated earnings tax.\(^8\)

A. ELECTION OF DISC STATUS\(^9\)

The election to be treated as a DISC must be made within 90 days preceding the beginning of the taxable year. All shareholders of the corporation on the first day of the first taxable year of the election must consent.\(^50\) The election need only be made once. Thereafter it is binding upon all subsequent shareholders. However, the DISC may terminate the election at will within 90 days of the beginning of any taxable year after the first. Alternatively, if the DISC fails to satisfy the percentage qualification tests for five consecutive years, the election will automatically terminate. The corporation may later make a new election following either a voluntary or involuntary termination.

B. QUALIFIED EXPORT RECEIPTS\(^21\)

The 95% qualified export assets and receipts requirements are the crucial tests in maintaining DISC status. These closely related tests combine to limit the scope of activities in which the DISC will be permitted to engage. Qualified export receipts benefits extended to Western Hemisphere Trade Corporations (I.R.C. § 922) and the Possession Corporation (I.R.C. § 931) if it elects DISC status or owns stock in a DISC.

18. I.R.C. § 991. The DISC is subject only to the tax imposed by I.R.C. § 1491 on transfers to avoid income tax. However, I.R.C. § 992(d) denies DISC status to personal holding companies.


are generated by eight categories of export-related activities, some active and some passive. The categories include: gross receipts from the sale or rental of export property;\(^{22}\) gross receipts from services related and subsidiary to such sales or rentals;\(^{23}\) gain realized from the sale of qualified export assets other than inventory;\(^{24}\) dividends from a related foreign export corporation;\(^{25}\) interest on any obligation which is a qualified export asset; gross receipts with respect to engineering or architectural services on foreign construction projects; and gross receipts from the performance of managerial services for any non-related DISC\(^{26}\) in furtherance of the production of qualified export receipts.

To ensure that receipts will be generated by transactions which further the purpose of the statute, the Treasury is authorized by Section 993(a)(2) of the Internal Revenue Code to issue regulations disqualifying certain receipts which would otherwise meet the statutory requirements. Receipts subject to disqualification are those where the sale, rental or related service: 1) is for ultimate use in the United States; or 2) is supported by federal programs designed to subsidize exports;\(^{27}\) or 3) is directly

\(^{22}\) Export property, generally the DISC's inventory, is property produced in the United States by a producer other than the DISC for use or consumption outside the United States. I.R.C. § 993(c). For detailed treatment of export property, see text accompanying notes 33-38 infra. If the DISC merely receives a commission from the domestic manufacturer for its export transactions, the "gross receipts" for those commission transactions include the entire proceeds of the sale or rental rather than merely the commission. I.R.C. § 993(f). For purposes of the 95% receipts test, this rule provides a commission-earning DISC with treatment identical to that of a DISC which sells or rents from its own inventory of export property.

\(^{23}\) The distinction between services which are "related and subsidiary to" the basic export transaction and those services which are related but not "subsidiary" is illustrated by this Committee example:

For example, if a corporation sells a business machine which is export property and contracts to service the machine, the gross receipts from the services are qualified export receipts. However, if a corporation is engaged to render services and as an incidental part of the services sells export property, the gross receipts from the services are not qualified export receipts since such services are not subsidiary although they are related to such sale.

\(^{24}\) I.R.C. §§ 993(a)(1)(D), 993(f); COMMITTEE EXPLANATION, supra note 6, at 106. Qualified export assets are discussed in Part III (C) infra.

\(^{25}\) Related foreign export corporations are discussed in text accompanying notes 62-69 infra.

\(^{26}\) I.R.C. §§ 993(a)(1)(H), 993(a)(2).

\(^{27}\) E.g., COMMITTEE EXPLANATION, supra note 6, at 99 (sale of agricultural products under P.L. 480).
or indirectly for use by a United States government agency which is obligated to use domestic goods.\textsuperscript{28} Disqualification of receipts, according to the Committee Explanation, will depend upon the relationship between the DISC and its customer. If a related customer later uses or resells the property in the United States, the receipts will be automatically disqualified. However, a sale or rental to an unrelated customer will be disqualified only if made "pursuant to an agreement or understanding that the property would be used in (or resold for use in) the United States or if a reasonable person would have [so anticipated]."\textsuperscript{29} This rule eases the danger of adverse consequences to the DISC which might otherwise arise from the unanticipated use of the property by an unrelated customer whose activities cannot be influenced by the DISC. Treasury Regulations must define the degree of relationship necessary to make a customer "related" for purposes of this rule. However, the relationship specified should make little difference in result. Even if a rather substantial relationship is required to make the customer related, it would seem that the existence of almost any degree of relationship would make it difficult for the DISC to prove that the customer's ultimate use of the property could not have been anticipated by a reasonable person.

C. \textbf{QUALIFIED EXPORT ASSETS}\textsuperscript{30}

To encourage domestic producers to take advantage of the DISC, Congress considered it essential to permit sufficient opportunities for utilizing the DISC's tax deferred income. Therefore, for purposes of the 95\% assets requirement, qualified export assets include both the usual operating assets of the export business and also certain investment assets, the most important of which is the producer's loan. The 95\% qualified export assets requirement is determined by comparing the adjusted basis of qualified export assets with the adjusted basis of all assets owned by the DISC at the close of the taxable year. The test permits the DISC to own non-qualified assets which have appreciated in value without being disqualified.\textsuperscript{31} However, owner-

\textsuperscript{28} Any sale to a foreign wholesaler who is known to be a supplier of goods to the United States Army, for example, would be an indirect sale subject to disqualification. \textit{Id.}

\textsuperscript{29} \textit{Id.} at 98-99.

\textsuperscript{30} \textit{I.R.C.} §§ 992(a) (1) (B), 993(b).

\textsuperscript{31} \textit{I.R.C.} § 992(a) (1) (B). This would not have been possible under an earlier version of the DISC statute which would have required
ship of such assets is quite risky, because if the DISC should have to resort to a distribution to meet qualification requirements, it would be forced to distribute an amount equal to the fair market value of all non-qualified assets.\footnote{32}

1. Export Property\footnote{33}

The primary category of qualified export assets is “export property.” This is any property, generally inventory, which is manufactured, grown or extracted in the United States\footnote{34} by a person other than the DISC and which the DISC sells or rents for use or consumption outside the United States.\footnote{35} This definition of export property effectively prohibits the DISC from engaging in manufacturing. However, the Committee Explanation indicates that the DISC may perform minor packaging and assembly operations if such operations do not “substantially transform” the article. Similarly, if the DISC contributes less than 20% of the cost of the finished product, the DISC will not be considered engaged in manufacturing and the product will qualify as export property.\footnote{36} In addition, not more than 50% of the fair market value of export property may consist of the value of components imported into the United States.\footnote{37}

\footnote{32} Distributions to meet qualification requirements are made to preserve DISC status when one or both of the 95% tests are not met. See text accompanying notes 73-80 infra.

\footnote{33} I.R.C. §§ 933(b) (1), 993(c).

\footnote{34} The “United States” includes Puerto Rico and the possessions of the United States, i.e., the Virgin Islands, Guam, and American Samoa. I.R.C. § 993(g). Thus inventory destined for use in those areas will not constitute export property for purposes of either the assets or receipts requirements. Conversely, goods manufactured in those areas will constitute export property.

\footnote{35} This destination test offers a possible means of avoiding foreign taxation. If a foreign country adopts a title-passage test as the criterion for its taxing jurisdiction, the DISC could have title pass in the United States (since that would be irrelevant to U.S. taxation) and thereby avoid foreign taxation. See Bagley, A DISC in Your Future, 48 TAXES 548, 555 (1970).

\footnote{36} COMMITTEE EXPLANATION, supra note 6, at 100. The statute itself makes no reference to the “substantial transformation” and 20% added-cost tests. Presumably these tests will be embodied in forthcoming Treasury Regulations. See also, Treas. Reg. 1.954-3(a)(4) (1964) (similar tests for determining whether a controlled foreign corporation is engaged in manufacturing).

\footnote{37} The fair market value of the imported component is its appraised value under the Tariff Act of 1930. The United States manufacturer will furnish the DISC with a certificate regarding the foreign
It was feared that some domestic corporations would use DISC subsidiaries to obtain deferral of manufacturing income by the transfer to the DISC and subsequent lease-back of property required by the parent in its foreign operations. This maneuver is prohibited by Section 993(c)(2), which excludes from export property any property rented by a DISC to a member of its controlled group. Also excluded from export property are intangibles such as patents, designs, formulas, copyrights (with exceptions), goodwill, franchises, and similar property. Finally, the President is given the power to exclude by executive order any property which he believes is in insufficient supply to meet the requirements of the domestic economy.

2. Operating Assets

Qualified export assets also include the operating assets of the export business. These are described as assets used primarily in connection with the sale, lease, rental, storage, handling, transportation, packaging, assembly or servicing of export property. Also included are those assets used in providing management service to non-related DISCs, and in providing engineering and architectural services on foreign projects.

3. Producer's Loans

One of the most innovative features of the DISC provision is the concept of the producer's loan, a type of qualified asset which permits the DISC to loan its "accumulated DISC income" to any United States producer of export property, including its parent corporation. The producer's loan must be designated as such when made and must be evidenced by a note with a maturity date of not more than five years. In addition, two limitations imposed at the borrower level govern the amount of the loan and the use of the proceeds.

content of the goods. Even if the imported articles themselves contain U.S. components, they will still be treated as wholly foreign for this purpose. COMMITTEE EXPLANATION, supra note 6, at 101.

38. A controlled group for DISC purposes is defined by I.R.C. § 993(a)(3) which is a more inclusive version of I.R.C. § 1563(a). Where I.R.C. §1563(a) requires 80% control in determining parent-subsidiary and brother-sister controlled groups, the DISC provision reduces the control requirement to 50%.


40. I.R.C. §§ 993(b)(5), 993(d).

41. "Accumulated DISC income" is the tax deferred portion of DISC earnings and profits. See text accompanying notes 100-103 infra.
Under the first limitation, the amount of producer's loans which a borrower may have outstanding is limited to the amount of its export-related assets at the beginning of the taxable year. This limitation is determined by multiplying an asset base consisting of inventory, United States production facilities and research and development expenditures by the percentage of total receipts attributable to sales of export property.\textsuperscript{42} The second limitation is an "increased investment requirement," imposed to ensure that the borrower uses the proceeds to expand its export-related assets, i.e., those assets forming the asset base in the first limitation.\textsuperscript{43}

Several aspects of the producer's loan provision may inhibit its usefulness. For example, the first limitation is drafted in a

\textsuperscript{42} Specifically, the first limitation is computed as follows:

(1) Determine the asset base at the beginning of the borrower's taxable year, which is the sum of the borrower's:

- adjusted basis in plant, machinery, and equipment, and supporting production facilities in the United States, plus
- inventory, plus
- the aggregate amount of research and experimental expenditures in the United States during all taxable years beginning after 1971.

(2) Using only receipts from taxable years beginning after 1971, determine for the three preceding taxable years the percentage of total receipts from the sale or rental of inventory which is attributable to the sale or rental of property which would be "export property" if held by a DISC.

(3) Multiply the asset base obtained in (1) by the percentage of export sales obtained in (2). The product of these figures represents the export-related assets of the borrower which is the ceiling on outstanding producer's loans available to it. I.R.C. § 993(d) (3).

The Committee Explanation indicates that for purposes of this limitation the borrower may elect to take into account the export sales and export-related assets of all non-DISC members of its controlled group. COMMITTEE EXPLANATION, supra note 6, at 104. However, the statutory provision upon which this language originally was based, H.R. 18970, 91st Cong., 2d Sess., § 993(d) (2) (1970), was deleted without explanation from the final enactment.

\textsuperscript{43} Specifically, the increased investment requirement is computed by adding the following items:

(1) The amount by which the borrower's adjusted basis on the last day of the taxable year of plant, machinery, and equipment, and supporting production facilities in the United States and inventory exceeds the adjusted basis of such assets at the beginning of the year, plus

(2) the amount of the borrower's research and experimental expenditures (I.R.C. § 174) in the United States during the taxable year.

The DISC is permitted to treat a loan as a producer's loan to the extent that the loan, when added to the unpaid balance of other producer's loans obtained by the borrower during the taxable year, does not exceed the increased investment requirement computed above. I.R.C. § 993(d) (3).
manner which not only limits the borrower's allowable loans to the amount of its United States based assets, but the ceiling is reduced further if the borrower's receipts include sales of goods manufactured abroad. The further reduction is due to the fact that the asset base (already reduced to exclude foreign based assets) is multiplied by the percentage of receipts attributable to sales of "export property." By definition, export property must be produced in the United States. Therefore, any goods produced abroad, even if they are sold abroad, will reduce the applicable percentage. To illustrate, assume that Company X and Company Y both sell their entire output abroad and that each company has $500,000 in United States facilities. Assume further that Company Y also owns an identical facility overseas which accounts for 50% of its sales. Following the computation as set forth in footnote 42, the ceiling on producer's loans available to each company is determined as follows:

<table>
<thead>
<tr>
<th></th>
<th>Company X</th>
<th>Company Y</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted basis in all plant, machinery, etc.</td>
<td>$500,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>(1) Adjusted basis in U.S. plant, machinery, etc.</td>
<td>$500,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>(2) Percentage of receipts attributable to sales of export property:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company X (all output is produced in the U.S. and sold abroad, thus all receipts qualify as sales of export property):</td>
<td>× 100%</td>
<td></td>
</tr>
<tr>
<td>Company Y (all output is sold abroad but only 50% is produced in the U.S.; export property by definition must be produced in the U.S. and therefore only half of total receipts qualify as sales of export property):</td>
<td>× 50%</td>
<td></td>
</tr>
<tr>
<td>(3) Ceiling on outstanding producer's loans:</td>
<td>$500,000</td>
<td>$250,000</td>
</tr>
</tbody>
</table>

Despite the fact that both companies export their entire United States output and have identical United States production facilities, Company Y would be able to obtain only half the producer's loans available to Company X solely because of the cumulative effect of ownership of foreign based assets. The Committee Explanation indicates that the purpose of this limitation is to limit producer's loans to the amount of the borrower's assets considered "related to its export sales." Since the percentage of receipts attributable to sales of export property accurately measures the extent of the borrower's export activity, the purpose of the limitation would have been achieved without the addi-

44. I.R.C. § 993 (c) (1) (A).
45. COMMITTEE EXPLANATION, supra note 6, at 103.
tional requirement that the asset base be limited to assets located in the United States.

The second limitation, the increased investment requirement, is measured by the increase during the taxable year in the adjusted basis of designated assets. The use of adjusted basis as the criterion may cause serious problems because of the effect on adjusted basis of events totally unrelated to the objective of increasing United States based export capacity. Consider Company Y in the previous illustration, which begins a $250,000 expansion of its U.S. plant and equipment financed completely by a producer’s loan. Assume the following events occur during the year and consider the effect of each event on adjusted basis:

<table>
<thead>
<tr>
<th>Date</th>
<th>Transaction or Event</th>
<th>Increase/ Decrease</th>
<th>Adjusted Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan. 1</td>
<td>Beginning adjusted basis in U.S. plant</td>
<td>$500,000</td>
<td></td>
</tr>
<tr>
<td>June 1</td>
<td>Construction of new U.S. plant, financed in full by a producer’s loan</td>
<td>Increase +250,000</td>
<td></td>
</tr>
<tr>
<td>Dec. 15</td>
<td>Fire completely destroys a U.S. plant, adjusted basis $180,000</td>
<td>Decrease -180,000</td>
<td></td>
</tr>
<tr>
<td>Dec. 20</td>
<td>Sale of U.S. equipment, adjusted basis $20,000</td>
<td>Decrease -20,000</td>
<td></td>
</tr>
<tr>
<td>Dec. 31</td>
<td>Annual depreciation allowance</td>
<td>Decrease -40,000</td>
<td></td>
</tr>
<tr>
<td>Dec. 31</td>
<td>Adjusted basis in U.S. plant, equipment on last day of taxable year</td>
<td>$510,000</td>
<td></td>
</tr>
</tbody>
</table>

The increase in the adjusted basis of Company Y’s United States plant and equipment from the beginning to the last day of the taxable year is only $10,000. Thus the $250,000 loan which appeared when made on June 1 to qualify in full as a producer’s loan suddenly qualifies only to the extent of the $10,000 increase in adjusted basis of the designated assets. The likely consequence to the DISC is failure to meet the 95% qualified export assets requirement since $240,000 of the $250,000 loan will not qualify as a producer’s loan.

It may be reasonably assumed that Congress did not intend an involuntary conversion such as a fire to disqualify a producer’s loan. Depreciation may or may not have been intended as a limiting factor. Arguably, since depreciation is not intended to measure the actual contraction of the borrower’s export production capability, the annual allowance should not limit allowable producer’s loans. The Treasury Department should

46. I.R.C. § 1016.
47. Perhaps it could be argued that “adjusted basis on the last day of the taxable year” does not include the adjustment for annual depreciation. Arguably, the depreciation adjustment is made after the
consider alleviating the danger of retroactive disqualification of producer's loans caused by the borrower's failure to meet the increased investment requirement. For example, the regulations might require that increases in adjusted basis be offset only by events and transactions which represent a voluntary contraction of the borrower's export producing capability, e.g., the sale of export-related assets. There is no indication that such an administrative interpretation would be contrary to the intent of Congress. In fact, the language of the Committee Report appears contradictory on the question of retroactive disqualification caused by failure of the borrower to meet the increased investment requirement. It is stated that "[i]f a loan . . . qualifies as a producer's loan . . . at the time when the loan is initially made, it is to remain a producer's loan until its maturity."48 This language would save the $250,000 loan in the previous illustration since that loan appeared to qualify when it was made. However, the paragraph immediately preceding the above extract states that "a loan can qualify as a producer's loan only to the extent that the DISC is able to show that at the end of the year of the loan the borrower increased its [export-related assets] by an amount equal to the loan."49 The apparent inconsistency is probably due to the fact that the first extract was originally written when the DISC proposal did not contain the increased investment requirement.50 In order to avoid rendering the increased investment requirement meaningless, the first extract must be read as applying only to the first limitation (the ceiling on outstanding producer's loans). Thus it appears that the retroactive disqualification of a loan which appeared to qualify when made is a very real possibility under the increased investment requirement, absent any forthcoming relief from the Treasury.

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48. COMMITTEE EXPLANATION, supra note 6, at 104. (Emphasis added.)
49. Id. (Emphasis added.)
50. The extract cited in the text accompanying note 48 originally appeared in H.R. REP. NO. 91-1435, 91st Cong., 2d Sess. (1970). The Committee Explanation accompanying the final enactment appears to have been inadequately amended to reflect the subsequent addition of the increased investment requirement.
The increased investment requirement also may be a problem if the borrower seeks to extend a producer's loan beyond maturity. The statute is silent on the issue of renewal but the Committee Explanation states:

If at its maturity the borrower's limitation is sufficient to permit a new loan in the amount of the old loan, then the old producer's loan could be renewed for an additional stated period of up to 5 years and then would qualify as a producer's loan for that period.\(^{61}\)

Presumably "borrower's limitation" refers to the overall ceiling on producer's loans rather than to the increased investment requirement. However, the Treasury's informal explanation states that "[a] loan that is extended at maturity will be treated as a new loan and the DISC and the borrower must meet the above tests on the date of the extension."\(^{52}\) If the Treasury contemplates treating renewals as new loans, the borrower presumably would have to fulfill the increased investment requirement. However, to require the renewal to be plowed into new investment would negate completely the borrower's ability to renew existing loans. On the other hand, if the increased investment requirement need not be met in the year of renewal, then the sting of the statutory five year maturity is reduced significantly and the DISC is well on the way to a permanent tax deferral achieved by successive five year renewals. Resolution of the renewal issue by the Treasury will have a significant effect on the amount of expansion to be financed by producer's loans.

4. Accounts Receivable and Other Obligations\(^{53}\)

Accounts receivable and other evidences of indebtedness arising from specified transactions constitute another category of qualified export assets. This provision will allow a DISC to develop foreign markets by financing its foreign customers, including affiliates. Such financing would be limited, however, to a deferred payment arrangement applicable only to export trade receivables which arise from sales by the DISC (or through a commission-earning DISC) to the foreign buyer.

The statute also extends qualified export asset treatment to obligations arising from the sale of assets, other than inventory, which themselves were qualified export assets in the hands of

51. COMMITTEE EXPLANATION, supra note 6, at 104.
53. I.R.C. § 993(b)(3).
the DISC. This provision appears to permit the DISC to participate in financing arrangements contradictory to the purposes underlying the act. By selling qualified export assets (other than inventory) in exchange for long term debt obligations, the DISC is able to extend its financing function beyond the constraints imposed on producer's loans and the financing of export trade receivables. The only requirement is that the asset disposed of must have been used in the DISC's export activities to the extent necessary to withstand attack on its qualified status. For example, assume the DISC owns a warehouse (qualified export asset) which is expendable to its export operations. The warehouse could be sold on a long term installment contract. The resulting obligation will be a qualified export asset in the hands of the DISC; the interest received will be a qualified export receipt. Further, the resulting obligation will be treated more favorably than if the DISC had made a producer's loan. For example, the borrower will not be subject to the producer's loan requirement that its export-related assets be increased by the amount of the loan. In fact, the borrower could convert the warehouse from an export storage facility to an import facility, a use which is completely counterproductive to the stated objective of increasing exports. Meanwhile, the DISC's shareholders receive a windfall in the form of a 50% tax deferral on the interest income. This is in sharp contrast to the treatment of interest on producer's loans, which is fully taxable to the shareholders. Unlike producer's loans, these obligations would be unaffected by other foreign investment by the controlled group of which the DISC is a member. The earlier version of

54. I.R.C. § 993(b) includes in the definition of qualified export asset the following subparagraph:

(3) accounts receivable and evidences of indebtedness which arise by reason of transactions of such corporation described in subparagraph (A), (B), (C), (D), (H), or (G), of subsection (a) (1).

Subparagraphs (A), (B), (C), (H), and (G) of I.R.C. § 993(a) (1) merely enumerate the normal business activities of the DISC. However, the transaction described in subparagraph (D) of subsection (a) (1) is the "sale, exchange, or other disposition of qualified export assets (other than export property)."

55. Transportation equipment, storage facilities and facilities used in the assembly work which the DISC may engage in are only a few of the examples of assets which could be disposed of in this manner.

56. I.R.C. § 993(a) (1) (F).
57. I.R.C. § 995(b) (1) (A).
58. Taxation of foreign investment attributable to producer's loans is discussed in text accompanying notes 89-93 infra.
the DISC did not extend qualified export asset treatment to obligations of this type. The Committee Explanation makes no reference to such treatment, but it may have been felt that the DISC would be unduly restricted in disposing of its property if the resulting obligations were not qualified.

The provision should be amended, at the very minimum, to make interest on the obligations fully taxable in keeping with similar treatment of interest on producer’s loans. Serious consideration also should be given to complete disqualification of such obligations. If this imposes too great a restriction on the DISC’s disposition of property, the Treasury Department should be provided with the express power to prevent the use of the DISC as an agency for the financing of other than producer’s loans and export trade receivables.

5. Related Foreign Export Corporations

To provide the flexibility necessary to conduct overseas operations, the DISC is permitted to own stock in three types of “related foreign export corporations.” The first is a Foreign International Sales Corporation (FISC), which is described as a “foreign selling arm of the DISC.” The FISC is a foreign subsidiary, at least 50% of which is owned by the DISC, and which meets qualification requirements similar to those imposed on

60. The Committee Explanation indicates that qualified export assets include:

(3) accounts receivable and evidences of indebtedness of the corporation (or if the corporation acts as agent, the principal) held by the corporation which arose in connection with qualified export sale, lease or rental transactions (including related subsidiary services) or the performance of managerial, engineering, or architectural services producing qualified export receipts by the corporation.

COMMITTEE EXPLANATION, supra note 6, at 99. (Emphasis added.)

The italicized language represents the only changes in the corresponding language of H.R. Rep. No. 91-1435, 91st Cong., 2d Sess. (1970) (reporting H.R. 18970, supra note 59). The italicized language properly adjusts for the subsequent addition to I.R.C. § 993(b)(3) (accounts receivable and other evidences of indebtedness) of the references to subparagraphs (H) and (G) of subsection (a)(1) (i.e., engineering, architectural services, etc.). However, no clue is given as to the purpose of adding to § 993(b)(3) the reference to subparagraph (D) of subsection (a)(1) (i.e., sale of qualified export assets other than inventory).

61. A somewhat parallel provision governing the Export Trade Corporation limits the ETC to obligations arising from the sale of inventory and services. I.R.C. § 971(c)(4).
62. I.R.C. § 993(e).
63. COMMITTEE EXPLANATION, supra note 6, at 105.
the DISC, i.e., the 95% assets and receipts tests. However, by comparison to the DISC, a FISC is much more restricted in the assets and receipts which will be considered qualified.\footnote{64} The FISC, by definition, will meet the tests of a controlled foreign corporation for purposes of Subpart F.\footnote{65} Because the FISC will be selling personal property acquired from a related person and which was produced in a country other than the country of its incorporation, FISC income will be constructively distributed under Subpart F to its shareholders. However, the FISC may avoid Subpart F distributions if, for example, it sells only in the country in which it is incorporated. Even if Subpart F cannot be avoided, its effect on the DISC's parent corporation is reduced by 50%, the amount of DISC income which is tax deferred.

\footnote{64}{Qualified export assets of the FISC include export property, operating assets, trade receivables, obligations arising from the sale of qualified export assets other than inventory, and liquid assets reasonably necessary to meet its working capital requirements. I.R.C. § 993 (e) (1) (c). Holding liquid assets in excess of reasonable working capital requirements at year end causes the very real danger of accidental disqualification discussed in note 72 infra.}

\footnote{65}{Qualified export receipts of the FISC include gross receipts from the sale or rental of export property or services related to the sale or rental, gain on sale of qualified export assets other than inventory, and interest received on obligations which are qualified. I.R.C. § 993 (e) (1) (B). Under the literal wording of I.R.C. § 993 (e) (1) (B) & (C), only a foreign corporation selling for the DISC on a commission basis would be likely to meet the assets and receipts requirements. One FISC qualification requirement is that 95% of gross receipts consist of qualified export receipts, the most important of which is receipts from the sale of “export property.” I.R.C. § 993 (c) (1) (B) defines export property as inventory held for sale or rental “by, or to, a DISC.” Since inventory in the hands of the foreign corporation is held neither for sale by a DISC nor for sale to a DISC, it would not constitute export property for either of the 95% tests imposed on a FISC. However, a FISC selling on a commission basis would have no problem since it would be selling inventory held “by a DISC.” An analogous problem was recognized and remedied in I.R.C. § 993 (d) (2), a producer’s loan provision which involves determining the receipts from the sale of export-related property by a borrower. The earlier version of the DISC spoke of the borrower’s qualified export receipts from the sale of export property, language which would have raised the same problem as described above. However, the provision was revised to include “receipts . . . of property which would be export property if held by a DISC.” (Emphasis added.) Similar language should have been used in the FISC provision because the literal language of the statute simply does not implement the apparent intent of Congress that the FISC be allowed to sell from its own inventory. See COMMITTEE EXPLANATION, supra note 6, at 105, 108 (references to the FISC’s “inventory of export property” and to “sales by a DISC to its foreign affiliates”).}

I.R.C. §§ 951-64. See Part VI (A) infra, for discussion of Subpart F.
Therefore, if for either commercial or legal (or perhaps tax reduction) reasons the DISC feels that it would be advantageous to use a foreign corporation to handle its sales in a particular country or area, the stock will be a qualified export asset and amounts included in DISC income under Subpart F will constitute qualified export receipts. However, sales by the DISC to the FISC must be at arms length prices, subject to reallocation by the Internal Revenue Service (IRS) under Section 482 of the Code, rather than at the more favorable intercompany prices allowed on purchases by the DISC from related persons.

The second type of permissible foreign stock ownership is stock in a "real property holding company" of which the DISC owns at least 50%. The sole function of such foreign corporation is to hold title to real property for the exclusive use of the DISC.

The "associated foreign corporation," the third type of foreign corporation whose stock will constitute a qualified export asset, assists in promoting the DISC's foreign sales, usually by purchasing goods from the DISC. Ownership by the DISC must be reasonably in furtherance of transactions which generate qualified export receipts for the DISC, i.e., ownership necessary to maintain or obtain a customer or of assistance to the DISC's sales distribution system. The DISC may not own more than 10% of the stock of the associated foreign corporation, and its total investment must be reasonable in relation to the value of the business expected to be derived.

6. Miscellaneous Obligations and Working Capital

Finally, qualified export assets include obligations of the Export-Import Bank, the Foreign Credit Insurance Association.

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66. See Part VI(B) infra (discussion of possible tax reduction using the FISC).

67. COMMITTEE EXPLANATION, supra note 6, at 108. Since the FISC is a foreign corporation, presumably a favorable ruling from the I.R.S. pursuant to I.R.C. § 367 will be required to accomplish a tax-free incorporation of a FISC or the tax-free transfer of an existing foreign corporation to a DISC. The statute expressly waives the § 367 ruling requirement only with respect to the transfer to the DISC of the assets of an Export Trade Corporation (ETC). Revenue Act of 1971 § 505(b)(1)(A), Pub. L. 92-178 (Dec. 10, 1971).

68. COMMITTEE EXPLANATION, supra note 6, at 106 n.4.

69. Id.

70. The Export-Import Bank of the United States is an agency of the United States government established to aid in financing and to facilitate exports and imports. 12 U.S.C. § 635 (1964).

71. The Foreign Credit Insurance Association is:
and certain corporations whose loans are guaranteed by the Export-Import Bank. In addition, the DISC may have money, deposits and temporary investments in amounts sufficient to satisfy its reasonable working capital requirements. Amounts in excess of reasonable working capital requirements will be qualified only if held in a United States bank at the close of the taxable year and reinvested in qualified export assets within a certain time after the close of the year. This gives the DISC an opportunity to invest extraordinary or unexpected receipts, such as repayment of a producer's loan, without being subject to disqualification. 72

72. Treasury Regulations are expected to measure subsequent reinvestment by requiring that on the last day of the sixth, seventh and eighth months after the close of the taxable year, the DISC must own qualified export assets (other than deposits) in an amount equal to 95% of the total assets owned at the end of the taxable year. Bank deposits would not be traced to actual reinvestment under this method. COMMITTEE EXPLANATION, supra note 6, at 100. It must be noted that this six month escape clause protects only the DISC. A FISC subsidiary may become inadvertently disqualified by unusual year-end receipts because its qualified assets provision (I.R.C. § 993(e)(1)(C)) incorporates by reference the reasonable working capital allowance of I.R.C. § 993(b)(4), but not the subsequent reinvestment of excess working capital permitted the DISC by I.R.C. § 993(b)(9). Therefore, if it is determined that the FISC's liquid funds at the end of its taxable year are in excess of reasonable working capital requirements, the FISC might fail its 95% assets test. The consequences to the DISC of such an occurrence would be the disqualification of its FISC stock and its Subpart F income attributable to the FISC stock. If this caused the DISC to fail either of its 95% assets and receipts tests, the DISC would be forced to make a distribution to meet qualification requirements. See text accompanying notes 73-80 infra. This distribution must equal the fair market value of the FISC stock, all other non-qualified assets and the Subpart F income attributable to ownership of FISC stock, and any other non-qualified receipts, assuming both tests were failed. Needless to say, extreme caution should be exercised as the FISC approaches the close of its taxable year. The FISC's assets requirement can be met by distributing excess funds to the parent DISC or by purchasing qualified export assets. However, there may be no protective measures available to protect the FISC against accidental disqualification for failure to meet the 95% receipts test caused, for example, by a substantial insurance recovery.

The entire problem might have been avoided if the FISC were permitted to make a distribution to meet qualification requirements in the same manner as a DISC which fails to meet its qualification requirements. However, the provision which permits the DISC to preserve its status, I.R.C. § 992(c), is phrased in terms of a corporation
D. DISTRIBUTION TO MEET QUALIFICATION REQUIREMENTS

A DISC which does not meet the 95% tests for assets and receipts is permitted to satisfy either or both of the tests by making a "distribution to meet qualification requirements," which is normally fully taxable to the shareholder. The amount which must be distributed depends on which of the 95% tests is not met. If the assets test is not met, an amount equal to the fair market value of all non-qualified assets owned at year end must be distributed. If the receipts test is not met, an amount equal to the portion of taxable income which is attributable to non-qualified receipts must be distributed. If neither test is met, both distributions must be made.

Qualifying distributions are divided into two categories, one which automatically qualifies if certain conditions are met, and another which requires proof of a "reasonable cause" for failure to meet the 95% tests and for any delay in making the distribution. Automatic qualification of the distribution is available to the DISC if at least 70% of its assets were qualified export assets, at least 70% of its gross receipts for the year were qualified export receipts, and the distribution is made within 8½ months of the close of the taxable year.

If the 70% tests for automatic qualification cannot be satisfied or if the distribution occurs more than 8½ months from the close of the taxable year, the DISC must fall back on the "reasonable cause" provisions to qualify its distribution. The term is which does not satisfy a condition specified in I.R.C. § 992(a)(1)(A) or (B), both of which are applicable only to a DISC (i.e., the DISC's 95% assets and receipts tests).

73. I.R.C. § 992(c).

74. Failure to meet the 95% receipts test will be quite costly to the shareholders. The non-qualified receipts generate taxable income, 50% of which is currently taxable as part of the annual deemed distribution. I.R.C. § 995(b)(1)(D). See text accompanying notes 82-84 infra.

In addition, to preserve its status, the DISC is compelled to make an actual distribution equal to the amount of income attributable to the non-qualified receipts. Assuming sufficient accumulated DISC income (tax deferred earnings and profits), the entire distribution will be fully taxable. (See text accompanying notes 108-09). Therefore, if the DISC fails to meet the 95% receipts test and has $100 of income attributable to non-qualified receipts, $50 will be "deemed" distributed and $100 must be actually distributed, for a total distribution to the shareholder of $150. Assuming the taxpayer is a corporation, the $100 of disqualified income will result in a current tax of $72 (48% of $150).

75. The adjusted basis of qualified assets will be compared with the adjusted basis of all other assets on the last day of each month of the taxable year to determine if the 70% test is met. I.R.C. § 992(c)(3)(B).
not defined in the statute, but the Senate Committee Report states:

Generally, the reasonable cause requirement is to be considered as being satisfied where the action or inaction which resulted in the failure to meet the [95%] gross receipts or assets test (or failure to make the distribution earlier than when it was made) occurred in good faith.\(^76\)

Foreign expropriation and blocked foreign currency are given as examples of reasonable cause for failure to make the qualifying distribution within 8½ months. Examples of reasonable cause for failure to meet the 95% qualified export receipts test include a price adjustment by the IRS under Section 482 and an unanticipated insurance recovery.\(^77\) Where the qualifying distribution is not made within 8½ months of the close of the taxable year, the DISC must pay to the IRS, for each year of delay, a charge of 4½% of the entire distribution. This charge will be treated as interest expense for federal tax purposes.\(^78\)

Finally, there are two general requirements which apply to all distributions to meet qualification requirements: they must be effected pro rata among the shareholders and they must be designated at the time of the distribution as a qualifying distribution. The designation requirement prevents a DISC which previously has made a dividend distribution from reclassifying that distribution as a qualifying distribution if it later discovers that it has failed to satisfy one of the percentage tests.

Since the qualifying distributions are not considered attributable to export activities, they will be treated as United States source income to the shareholders.\(^79\) Thus foreign taxes paid by the DISC with respect to the amount distributed will not qualify for the foreign tax credit. In addition, the DISC's corporate shareholders usually will not be entitled to the intercorporate dividends received deduction for qualifying distributions.\(^80\)

IV. TAXATION OF DISC SHAREHOLDERS\(^81\)

To understand the taxation of DISC shareholders, it is necessary to keep in mind the competing policies underlying the provision, viz., to provide substantial stimulus to exports without

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76. COMMITTEE EXPLANATION, supra note 6, at 96.
77. Id.
78. I.R.C. § 992(c) (2) (B).
79. COMMITTEE EXPLANATION, supra note 6, at 95. I.R.C. §§ 861 (a) (2) (D), 901 (d).
80. See text accompanying note 108 infra.
granting undue tax advantages. The provision therefore allows partial tax deferral to encourage exporting, but denies or terminates the deferral of income which is not derived from export activities or which is withdrawn from the promotion of such activities.

A. Categories of Taxable Income

Taxation of DISC income occurs only at the shareholder level and is levied on three categories of income: actual distributions, deemed distributions, and gain on disposition of DISC stock.

1. Actual Distributions

Actual distributions occur when money or property is distributed to the shareholders either for normal dividend purposes or when the DISC is forced to make a distribution to meet qualification requirements. The taxability of an actual distribution depends upon its source. The source of the distribution in turn depends on various priority rules used to establish which of three tiers of earnings and profits—each with differing tax consequences—the distribution is considered as having been made from.

2. Deemed Distributions

"Deemed distribution" is the statutory term for DISC income which is currently taxable to the shareholders even though not actually distributed. Deemed distributions are of two types, the annual deemed distribution in qualified years and the deemed distribution of accumulated DISC income upon disqualification or voluntary termination of DISC status.

(a) The Annual Deemed Distribution

The following generalization serves as a starting point for the discussion of deemed distributions: The DISC will be deemed to have made a pro-rata distribution annually to its shareholders of 50% of its current earnings in each year that the qualification requirements are met; taxation of the remainder is deferred until it is actually distributed, the stock is disposed of, or DISC status terminates.

This generalization is subject to several very important exceptions. First, to determine the income figure used in measur-
ing the current earnings portion of the annual deemed distribution, DISC taxable income must be reduced by two items which are deemed fully distributed in each year: interest on producer's loans, and a portion of the gain realized by the DISC on the sale of property originally received by the DISC in a transaction in which the transferor obtained full or partial non-recognition of its gain. After subtracting these two items from taxable income, 50% of the balance is deemed distributed as the current earnings portion of the annual deemed distribution. Foreign investment attributable to producer's loans, the final component of the annual deemed distribution, is completely unrelated to taxable income. Essentially, this provision terminates the tax deferral where controlled group members borrow the DISC's tax deferred earnings to finance domestic expansion while using other funds for foreign investment. The computation of the annual deemed distribution and the earnings eligible for tax deferral may be illustrated as follows:

<table>
<thead>
<tr>
<th>Amount</th>
<th>Annual Deemed Distribution</th>
<th>Tax Deferred Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>DISC taxable income</td>
<td>$75,000</td>
<td></td>
</tr>
<tr>
<td>Less: interest on producer's loans</td>
<td>$-5,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>Less: previously non-recognized gain</td>
<td>$-2,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Balance: 50% deemed distributed, 50% is tax deferred</td>
<td>$68,000</td>
<td>34,000</td>
</tr>
<tr>
<td>Division of DISC taxable income</td>
<td>$41,000*</td>
<td>$34,000</td>
</tr>
<tr>
<td>Add: foreign investment attributable to producer's loans</td>
<td>$12,000</td>
<td>12,000</td>
</tr>
<tr>
<td>Annual Deemed Distribution</td>
<td>$53,000**</td>
<td></td>
</tr>
<tr>
<td>Tax deferred income</td>
<td>$34,000</td>
<td></td>
</tr>
</tbody>
</table>

* The amount of taxable income deemed distributed cannot exceed the current earnings and profits of the DISC.
** The total of the annual deemed distribution cannot exceed current and accumulated earnings and profits of the DISC.

83. In the case of a producer's loan to the parent corporation, the deemed distribution of interest paid will completely offset the parent's interest deduction. Compare the full taxation of interest on producer's loans with the deferral permitted with respect to interest earned on bank deposits, financing of export trade receivables, and on obligations arising from the sale of qualified export assets (other than inventory). Logically, only the interest on export receivables should be deferrable since the other types of interest are not derived from export activities.

84. The annual deemed distribution is considered received by the shareholders on the last day of the DISC's taxable year. I.R.C. § 995
Two of the components of the annual deemed distribution, previously non-recognized gain and foreign investment attributable to producer's loans, require further discussion.

(1) Previously non-recognized gain

The previously non-recognized gain portion of the annual deemed distribution is defined by two rules which operate exclusively upon gain realized by the DISC on disposition of property originally acquired in a non-recognition transfer. The rules do not measure realized gain, but instead operate to identify segments of realized gain which will be treated differently.

The first rule is intended to prevent the transfer to the DISC of assets, such as appreciated securities, which will not be qualified export assets in the hands of the DISC. Upon disposition of the property by the DISC, the realized gain is deemed distributed to the full extent of the transferor's previously non-recognized gain. Therefore, since this portion of the annual deemed distribution is always taxed as ordinary income, a shareholder would be advised to keep the property in order to obtain capital gain treatment upon disposition.

The second rule applies to the disposition by the DISC of qualified export assets (other than inventory). The DISC's realized gain is deemed distributed, but only to the extent that the previous transferor, if he had sold the property instead of transferring it to the DISC, would have been required to recognize ordinary income. Under this rule, the transfer to the DISC

(b) (1). This allows the shareholders to postpone taxation of the annual deemed distribution for as long as eleven months if the DISC elects a fiscal year ending one month later than the shareholder's. For example, if the DISC selects January 31 as its fiscal year end, DISC earnings for February through December of 1972 and the month of January 1973 would be deemed distributed on January 31, 1973, but would not be reported by a calendar year shareholder until December 31, 1973. Similar staggering of the fiscal year end of a FISC subsidiary will further postpone taxation to the parent since FISC earnings, if subject to Subpart F, flow through the DISC.

85. I.R.C. § 995(b) (1) (B) & (C).
86. Since the deemed distribution is pro rata irrespective of which shareholder contributed the appreciated property, it may be possible to spread the potential gain of one shareholder among several shareholders. However, if the shareholders were related, I.R.C. § 482 could be used to reallocate the gain. The pro rata distribution should caution unrelated shareholders to be wary of the potential tax liability which accompanies the tax free contribution to the DISC of appreciated property.

87. E.g., depreciation recapture under I.R.C. §§ 1245, 1250.
of a qualified export asset which has appreciated may generate a slight tax saving upon subsequent disposition. The portion of the appreciation subject to recapture will be taxed fully regardless of who makes the sale, but the balance of the appreciation is treated differently. If the parent retains the property, the appreciation not subject to recapture will be taxed at the corporate capital gains rate of 30%. However, if the property is sold by the DISC, the effective rate of tax on the appreciation not subject to recapture will be 24% (only half of the appreciation will be deemed distributed and currently taxed at the normal corporate rate of 48%).

(2) Foreign Investment Attributable to Producer's Loans

The final component of the annual deemed distribution is foreign investment attributable to producer's loans. The purpose of this very complex provision is to prevent members of the DISC's controlled group from utilizing the DISC's tax deferred earnings to finance domestic expansion thereby releasing other funds for foreign investment. The tax deferred status of earnings loaned out as producer's loans is terminated to the extent of foreign investment. This treatment compliments the increased investment requirement of the producer's loan provision, which requires the borrower to increase its United States based assets by the amount of the loan. Without termination of the tax deferral, the increased investment requirement alone would not prevent the use of other controlled group funds for foreign investment.

This portion of the annual deemed distribution is computed by determining the smallest of three year-end amounts: 1) the net increase in foreign assets of the controlled group of which the DISC is a member; or 2) the actual foreign investment by do-

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88. The current tax saving could be eliminated later if the tax deferred portion of the gain is distributed.
89. I.R.C. §§ 995(b) (1) (E), 995(d).
90. The controlled group for DISC purposes is defined at note 38 supra.
91. The net increase in foreign assets of the group is measured as follows:
   (1) Gross increase in foreign assets, which is the amount incurred by the controlled group to acquire property described in I.R.C. § 1231(b) (realty or depreciable property used in the trade or business), less
   (2) The sum of five designated sources of foreign investment funds:
       (a) post-1971 depreciation on foreign assets of the group,
domestic members of the controlled group; or 3) outstanding producer's loans by the DISC to members of the controlled group. (Producer's loans to non-members are not affected by this provision.) The computations of net increase in foreign assets and actual foreign investment is cumulative from 1971. Appropriate adjustment will be made each year for earnings which were deemed distributed in a prior year because of foreign investment.

Where a FISC subsidiary is utilized in handling foreign sales, the DISC probably will have to use the net increase in foreign assets test in measuring this portion of the annual deemed distribution. FISC membership in the controlled group is a neutral factor in the net increase test since 95% of the FISC's assets must be qualified export assets which are not considered part of the net increase in foreign assets. However, it would be difficult to avoid a deemed distribution under the actual foreign invest-

(b) outstanding stock and debt of the group issued after 1971 to non-member foreign persons,
(c) 50% of the post-1971 earnings and profits of foreign members and foreign branches of the group,
(d) 50% of the post-1971 royalties and fees paid by foreign members to domestic members, and
(e) the uncommitted transitional funds of the group, which consist of two types of funds:
(1) the amount of foreign capital raised by issuing stock or debt to non-member foreign persons from 1968 to 1971, reduced by the net amount of funds transferred by domestic members to foreign members or branches while such stock was outstanding (the foreign stock and debt must constitute long-term foreign borrowing for purpose of the Foreign Direct Investment program of the Department of Commerce, H.R. (CONFERENCE) REP. No. 92-708, 92d Cong., 1st Sess. at 53 (1971) ), and
(2) the liquid assets of foreign members and branches on October 31, 1971, in excess of their reasonable working capital needs.

Qualified export assets, or assets which would qualify if owned by a DISC, are not considered in determining either the gross increase in foreign assets or the offsetting depreciation on foreign assets.

92. Actual foreign investment is the amount of funds treated as having been transferred abroad by domestic members of the group and is made up of the sum of the following items:
(1) post-1971 contributions by domestic members to the capital of foreign members, plus
(2) outstanding stock and debt of foreign members, issued after 1971 to domestic members (not including trade receivables), plus
(3) post-1971 transfers by domestic members to foreign branches, plus
(4) 50% of the post-1971 earnings and profits of foreign members and branches.
93. I.R.C. § 995(d) (5).
ment test since 50% of the FISC's earnings and profits plus any post-1971 domestic investment in the FISC will be treated as actual investment.

Although this provision will limit foreign investment by a controlled group which utilizes producer's loans, the restriction is not harsh. Reasonable opportunity for foreign expansion is allowed under the net increase test by provisions which allow expansion to the extent of 50% of post-1971 earnings and profits of foreign subsidiaries and foreign branches, post-1971 depreciation on foreign assets, and several lesser items.

(b) Deemed Distributions Caused by Loss of DISC Status

In addition to the annual deemed distribution, a second type of deemed distribution occurs when the DISC election is terminated voluntarily or if the DISC is disqualified for failing to meet the qualification requirements for five consecutive years. In either case, the accumulated DISC income (tax deferred earnings and profits) is deemed distributed pro-rata to the shareholders in equal annual installments over a ten year period following the disqualification or termination.94

(c) Basis Adjustments

Since the shareholder is taxed on income not actually received, he is permitted to treat both the annual deemed distribution and a deemed distribution caused by loss of DISC status as a contribution to capital which increases the basis of his stock by the amount of the deemed distribution.95 When earnings which were deemed distributed later actually are distributed, the distribution is treated as a tax free return of capital and the share-

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94. However, if the DISC had been qualified for less than 10 years, the installments would be deemed made over a period equal to its consecutive years of qualification. These deemed distribution installments continue even if the corporation subsequently requalifies for DISC treatment. If any actual distribution is made during the installment period, it is treated as the payment of the final installment. Thus, the shareholder would be taxed not only on the current deemed distribution installment, but also on the actual distribution since it would be treated as having accelerated the final installment. COMMITTEE EXPLANATION, supra note 6, at 113-14. When it is advantageous, a controlling shareholder always can accelerate the taxation of a series of deemed distributions by simply making actual distributions in the amount desired. Of course, this possibility exists whenever the DISC has accumulated DISC income (tax deferred earnings and profits).

95. I.R.C. § 996(a) (1).
holder must reduce his basis accordingly. However, to the extent that receipt of previously taxed income would reduce the basis below zero, capital gain is recognized.\textsuperscript{96}

3. \textit{Reclassification of Gain on Disposition of DISC Stock}

The third category of taxable income arises on the disposition of DISC stock. When the disposition is by sale or redemption, the price received usually will reflect the value of accumulated earnings and profits, some of which will be attributable to accumulated DISC income (tax deferred earnings and profits). The statute prevents the selling shareholder from converting into capital gain that income which would be ordinary income if distributed before the sale or redemption.\textsuperscript{97} The shareholder's gain is reclassified as ordinary dividend income to the extent that accumulated DISC income is attributable to his stock.\textsuperscript{98} Where the disposing shareholder is taxed in this manner, in effect a portion of accumulated DISC income has been taxed at the shareholder level. To prevent imposition of a second tax when this income is subsequently distributed, special adjustments are required which will be discussed below.

\textsuperscript{96} I.R.C. § 996(e) (2).

\textsuperscript{97} I.R.C. § 995(c). Contrast the treatment of the DISC shareholder with the selling shareholder in a typical domestic corporation. The latter receives capital gain treatment of income attributable to accumulated earnings and profits which would be ordinary income if distributed before the sale. However, the earnings of the typical corporation are subject to tax at both the corporate and the shareholder levels while DISC earnings are taxed only at the shareholder level.

\textsuperscript{98} Similar reclassification of shareholder gain is required when stock is transferred in a non-recognition transaction in which the DISC's corporate existence is terminated, e.g., a liquidation or certain reorganizations. COMMITTEE EXPLANATION, supra note 6, at 114-15. Realized gain attributable to accumulated DISC income must be reclassified as dividend income where the DISC's existence is terminated in an "A" reorganization (statutory merger or consolidation under I.R.C. § 368(a) ) or in a "C" reorganization (assets for stock under I.R.C. § 368(c) ). However, a "B" reorganization (stock for stock under I.R.C. § 368(b) ) will not normally require reclassification of gain because the DISC normally will remain in existence. Neither a divisive reorganization under I.R.C. § 368(d) nor an "F" reorganization (mere change in form under I.R.C. § 368(f) ) will be considered as terminating the existence of the DISC.

Inter vivos gifts and death transfers are not subject to this provision since neither involves recognition of gain.

Finally, the gain on a transfer of DISC stock to another corporation under I.R.C. § 351 in which boot is received would be subject to reclassification because gain is recognized by the disposing shareholder.
B. Divisions of Accumulated Earnings and Profits

The accumulated earnings and profits of a DISC are divided into three separate accounts for the purpose of identifying the source of the distribution and the corresponding tax consequences to the shareholders.

1. Accumulated DISC Income

The current earnings and profits, reduced by the amount of the annual deemed distribution, accumulate in this account during periods of DISC qualification. This tax-deferred income will be taxable as dividend income to the shareholders when actually distributed, or when deemed distributed upon termination of DISC status or upon disposition of DISC stock. Shareholders are not entitled to the intercorporate dividends received deduction of Section 243 of the Code on distributions from this account.

2. Previously Taxed Income

Previously taxed income is accumulated earnings and profits which were taxed to the shareholders in a deemed distribution, either the annual deemed distribution or a deemed distribution upon loss of DISC status. Because this income has been taxed to the shareholder, it will be tax free when distributed.

3. Other Earnings and Profits

The balance of accumulated earnings and profits not included in accumulated DISC income or in previously taxed income is simply termed “other” earnings and profits. This account represents earnings and profits earned while the corporation was not qualified as a DISC, and this income will be treated as dividend income upon distribution to shareholders. Because this income has already been taxed at the corporate level, corporate shareholders will normally be entitled to the intercorporate dividends received deduction, which is provided to alleviate the harshness of the triple taxation of corporate earnings which would otherwise occur. This problem does not exist with the DISC since its earnings are not taxed at the corporate level.
rate dividend received deduction on distributions from this account.\textsuperscript{105}

C. CORRELATION BETWEEN TAXABLE INCOME AND THE EARNINGS AND PROFITS ACCOUNTS\textsuperscript{106}

The DISC provision establishes a number of priority rules for identifying which of the three earnings and profits accounts is to be considered the source of a particular distribution. The source, in turn, determines the tax consequences to the shareholder. Where appropriate, this discussion will indicate the tax consequences in parentheses following the title of the account.

Regardless of when distributions were made or deemed made during the taxable year, they are considered as having been made in the following order:\textsuperscript{107}

(1) Deemed distributions;
(2) Actual distributions to meet qualification requirements;
(3) Other actual distributions.

The priority rule for determining the source of an actual distribution depends upon the purpose of the distribution. An actual distribution to meet qualification requirements is treated as having been made out of the earnings and profits accounts in the following order:\textsuperscript{108}

(1) Accumulated DISC income (dividend income);
(2) Other earnings and profits (dividend income, partially offset by the intercorporate dividends received deduction);
(3) Previously taxed income (tax-free).\textsuperscript{109}

This order maximizes the taxation of DISC shareholders, but the result was intended by Congress because this type of distribu-

\textsuperscript{105} I.R.C. §§ 243, 246(d). See exception to this statement at note\textsuperscript{112} infra.

\textsuperscript{106} I.R.C. § 996.

\textsuperscript{107} I.R.C. § 996(c).

\textsuperscript{108} I.R.C. § 996(a)(2).

\textsuperscript{109} I.R.C. § 997 alters the usual treatment of corporate shareholders who receive distributions of property. Under I.R.C. § 301, the amount distributed and the basis of the property in the hands of the corporate distributee is usually measured by the adjusted basis of the property in the hands of the distributing corporation. However, as to property distributed out of accumulated DISC income or out of previously taxed income, the distributee's basis and amount received is the fair market value of the property. Distributions out of other earnings and profits continue to be treated under I.R.C. § 301.
tion is made only when the DISC fails to meet the qualification requirements, i.e., the 95% qualified export assets and qualified export receipts tests. However, other actual distributions are considered to be deserving of more favorable treatment. Therefore, to facilitate the withdrawal of previously taxed income, other actual distributions are considered made out of earnings and profits in the following order:\textsuperscript{110} 

1. Previously taxed income (tax-free); 
2. Accumulated DISC income (dividend income); 
3. Other earnings and profits (dividend income, partially offset by intercorporate dividends received deduction).\textsuperscript{111} 

\textsuperscript{110} I.R.C. § 996(a) (1).

\textsuperscript{111} The following example closely parallels an example given in the COMMITTEE EXPLANATION, supra note 6, at 120 n.15. To illustrate the application of these priority rules, assume an existing corporation (owned by a single shareholder) with accumulated earnings and profits of $10, elects to be treated as a DISC. At the end of its first year of operation as a DISC, it has current earnings and profits of $4. The annual deemed distribution is $2 taxable as a dividend to the shareholder, increasing previously taxed income by the same amount. The remaining $2 of current earnings and profits becomes part of the accumulated DISC income account.

In April of the following year, the DISC makes a $6 actual distribution to meet qualification requirements for the previous year. In June, the stock of the DISC is acquired by another corporation in a tax-free "B" reorganization, which results neither in the recognition of gain nor in ordinary income treatment for the disposing shareholder. In September, the DISC makes an actual distribution to its new shareholder, the acquiring corporation, in the amount of $8. The DISC's current earnings and profits for its second year of operation are $6, of which $2 is interest on a producer's loan. The annual deemed distribution is $4 which consists of the $2 interest on producer's loans and 50% of the other taxable income.

Of the three distributions (the $6 qualifying distribution to the first shareholder, the $8 actual distribution to the new shareholder and the $4 annual deemed distribution to the new shareholder), the $4 annual deemed distribution is considered to have been made first. The deemed distribution thus is ordinary income to the new shareholder and increases previously taxed income by the same amount. (The other $2 of current earnings and profits is tax deferred and increases the accumulated DISC income account.)

The $6 distribution to meet qualification requirements of the previous year is considered to have been made next, and is considered to be out of accumulated DISC income to the extent of the account ($4), then out of other earnings and profits ($2). Thus the prior shareholder will have $6 ordinary income, of which $2 will qualify for the intercorporate dividends received deduction (because the income was taxed at the corporate level during a previous period of non-qualification as a DISC).

The $8 actual distribution is considered to have been made last and is considered first out of previously taxed income, of which the DISC
Deemed distributions are usually made only out of current earnings and profits (the annual deemed distribution) and out of accumulated DISC income (deemed distributions caused by loss of DISC status). However, a special priority rule became necessary when the Senate amended the annual deemed distribution provision, Section 995(b)(1) of the Code, to provide that foreign investment attributable to producer's loans would be deemed distributed to the extent of current and accumulated earnings and profits. The priority rule established for this particular portion of the annual deemed distribution is:

1. Accumulated DISC income (dividend income);
2. Other earnings and profits (dividend income, but in this particular case, there is no intercorporate dividends received deduction);\(^\text{112}\)
3. Previously taxed income (tax-free).

The third element of this priority introduces the rather curious and seemingly contradictory notion of a deemed distribution out of previously taxed income. According to Section 996(a)(3), such a distribution is tax free because "amounts distributed out of previously taxed income shall be excluded by the distributee has $6, next out of accumulated DISC income of which the DISC has none, and last out of other earnings and profits, of which the DISC has a sufficient amount to cover this portion of the actual distribution (§2).

Accordingly, the new shareholder would be considered, insofar as the actual distribution of $8 is concerned, as having received $6 tax-free from previously taxed income, none from DISC income (which would not have been eligible for the dividends received deduction) and $2 from other earnings and profits (which would be eligible for the dividends received deduction).

\(^\text{112}\) Generally, distributions out of "other earnings and profits" (earnings accumulated during periods of non-qualification) will qualify for the intercorporate dividends received deduction of I.R.C. § 243. However, the DISC statute amended I.R.C. § 246(d) to deny the intercorporate deduction with respect to dividends from a DISC "to the extent the dividend is paid out of the corporation's accumulated DISC income or previously taxed income or is a deemed distribution pursuant to section 995(b)(1)." (Emphasis added.) This provision predates the Senate amendment which added the annual deemed distribution of foreign investment attributable to producer's loans (I.R.C. § 995(b)(1)(E)). Absent that amendment, the italicized language of Section 246(d) would have been perfectly logical and necessary to prevent shareholders from receiving the dividends received deduction on the portion of the annual deemed distribution which is out of current earnings and profits (taxable only at shareholder level). However, under the Senate amendment it becomes possible to have a deemed distribution out of "other earnings and profits." Since the earnings accumulated in this account have already been taxed at the corporate level, there seems to be no valid reason to deny the intercorporate dividends received deduction.
from gross income . . . .” However, Section 995(b)(1) states just as emphatically that the annual deemed distribution “shall be taxable as a dividend” to the extent of current and, in this case, accumulated earnings and profits.¹¹³ The purpose of the annual deemed distribution of foreign investment attributable to producer’s loans is to terminate the tax deferral with respect to DISC earnings loaned to related borrowers who are simultaneously investing abroad.¹¹⁴ It would seem that this purpose would have been adequately implemented and the above problem avoided if the deemed distribution had been limited to the extent of accumulated DISC income, the only tax deferred portion of accumulated earnings and profits.

Various other adjustments must be made within the earnings and profits accounts when deemed distributions occur. The annual deemed distribution reduces current earnings and profits to the extent thereof.¹¹⁵ Since shareholders are taxed currently, the annual deemed distribution also increases previously taxed income.¹¹⁶ The balance of the current earnings and profits not deemed distributed becomes part of the accumulated DISC income account.¹¹⁷ Deemed distributions upon loss of DISC status reduce accumulated DISC income and increase previously taxed income since shareholders are taxed on the distributions.¹¹⁸

Adjustments to the earnings and profits accounts are also required when a disposing shareholder is required to reclassify his gain and report dividend income to the extent accumulated DISC income is attributed to his stock.¹¹⁹ In effect, accumulated DISC income is being taxed at the shareholder level although the earnings remain with the DISC. To prevent a second tax when this accumulated DISC income is subsequently distributed, and because only one shareholder is involved, a special adjustment is made at the shareholder level. The purchaser of the stock will be entitled to treat a subsequent actual distribution (or deemed

¹¹³ If the Treasury or the courts resolve the conflict in favor of a tax-free distribution of previously taxed income, it is safe to assume that the shareholder will not be entitled to an increase in the basis of his stock. A literal reading of I.R.C. § 996(e)(1) would allow a basis for any deemed distribution pursuant to Section 995(b), but the rationale underlying the basic increase is the fact that the shareholder is normally taxed on a deemed distribution.

¹¹⁴ Committee Explanation, supra note 6, at 91-92.

¹¹⁵ I.R.C. § 995(b)(1).

¹¹⁶ I.R.C. § 996(f)(2).

¹¹⁷ I.R.C. § 996(f)(1).

¹¹⁸ I.R.C. § 996(f)(1), (2).

¹¹⁹ See text accompanying notes 97-98 supra.
distribution caused by loss of DISC status), to the extent that his vendor was compelled to recognize dividend income, as if it were made from previously taxed income (tax-free). However, in the case of a redemption, the economic effect approximates an actual distribution of accumulated DISC income attributable to his shares. Therefore the accumulated DISC income account is simply reduced by the amount of gain which the redeeming shareholder was compelled to reclassify as dividend income.

Finally, losses incurred by the DISC are treated as reducing the earnings and profits accounts in the following order:

1. Other earnings and profits;
2. Accumulated DISC income;
3. Previously taxed income.

D. FOREIGN TAX CREDIT

The DISC statute provides that the foreign tax credit will be available to the shareholders of a DISC, amending Section 861 (a) (2) (D) of the Code to provide that distributions by a DISC will be considered to be foreign source income to the extent attributable to qualified export receipts. This amendment of the source rules entitles the corporate shareholder to the “deemed paid” foreign tax credit (Section 902) for any foreign income

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120. I.R.C. § 996(d) (1).

For example, assume that a shareholder in a DISC is required to treat $20 of his gain on the sale of his DISC stock as ordinary income. Although the accumulated DISC income and the previously taxed income of the corporation are not adjusted to reflect this ordinary income treatment, the purchaser is to treat up to $20 of a subsequent actual distribution (or a deemed distribution resulting from termination or disqualification) out of accumulated DISC income in the same manner as a tax-free distribution from previously taxed income. Thus, if the corporation made an actual distribution to the purchaser of $15 out of accumulated DISC income, he would not be taxed on this amount, even though the corporation itself had no previously taxed income.

COMMITTEE EXPLANATION, supra note 6, at 121 n.16.

121. I.R.C. § 996(d) (2).

122. If the DISC has terminated its election or has been disqualified and later requalifies as a DISC, a loss incurred after requalification cannot reduce accumulated DISC income attributable to a prior period of qualification. Thus, the installment distributions which begin upon termination of DISC status will continue regardless of subsequent losses. I.R.C. § 996(b) (3).

123. See also I.R.C. § 901(d). However, interest on producer's loans and previously nonrecognized gain, both of which are part of the annual deemed distribution, will not be considered foreign source income. I.R.C. § 881(a) (2) (D).
taxes paid by the DISC with respect to the DISC income distributed or deemed distributed. The statute also provides that the limitation on the foreign tax credit must be determined separately with respect to DISC income, and further, that the overall limitation of Section 904(a)(2) is not available for this purpose. Thus, the shareholder must apply the "per country limitation" of Section 904(a)(1) separately to its DISC income without regard to which election is in effect for his other income.\textsuperscript{124} The net effect is to prevent a shareholder using either the overall limitation or the per country limitation from applying any excess foreign tax credit (in the latter case, from a particular country) to reduce its United States tax liability with respect to DISC income.

V. INTERCOMPANY PRICING RULES\textsuperscript{125}

It has been a persistent problem with tax preferred entities to devise a proper method of establishing intercompany prices. The IRS has authority under Section 482 of the Code to reallocate profits, expenses, etc., if it believes that the existing allocation insufficiently represents the actual relationship between any related entities. It generally has insisted that the parent must sell its products to the subsidiary as in an arms length transaction.\textsuperscript{126} In other words, the parent must realize a legitimate profit and cannot attempt to concentrate the bulk of the profit with the tax preferred subsidiary. Thus even corporations attempting to be completely equitable in this respect can never be certain of avoiding a reallocation.\textsuperscript{127}

Pricing disputes on purchases by the DISC from related


\textsuperscript{125} I.R.C. § 994.

\textsuperscript{126} However, by far the most important difference between U.S. and foreign tax policy affecting foreign source income has been the U.S. policy since the early 1960's of strict enforcement of the arm's-length standard for intercompany pricing. While most other countries also have statutory provisions affecting inter-company pricing, no other country's administrative enforcement policy even approaches the attempted sophistication or severity of our own.

\textsuperscript{127} Such reallocation also could result in double taxation for the domestic corporation if its United States tax liability were increased and it could not recover any of the taxes paid to a foreign country on the same earnings.
suppliers should be minimized by a pair of intercompany pricing rules which have been described as the most significant feature of the entire DISC provision.\textsuperscript{128} Not only is certainty guaranteed, but the rules themselves will often allocate a greater than arms length share of the combined profit on an export transaction to the tax preferred DISC. In effect, the statute authorizes the very conduct which Section 482 is designed to prevent in other contexts.

The intercompany pricing rules do not measure the profit on an export transaction. Profit is measured in the normal manner by reducing gross receipts from the foreign customer by the cost of goods sold, selling and administrative expenses directly related to the sale, and indirect expenses allocated to the sale.\textsuperscript{129} In measuring the combined profit of the related entities, expenses are subtracted without regard to whether they were incurred by the related supplier or by the DISC.

The function of the two intercompany pricing rules is solely to allocate the combined profit between the DISC and its related supplier. The parties may select whichever rule proves most favorable, i.e., the rule which allocates the greater share of the combined profit to the tax favored DISC (see Example C below). Most significantly, the resulting allocation is immune from reallocation by the IRS under Section 482. When the combined profit is allocated under either rule, the intercompany transfer price is computed simply by determining the amounts which, when combined with the other expenses incurred by the respective entities, will yield the allocated profit to each.\textsuperscript{130} In fact,

\begin{itemize}
\item[128.] The essence of the DISC proposal consists of two elements: a revision of our intercompany pricing rules as applied to exports to put such rules more closely in line with those of other countries; and the opportunity to use a domestic subsidiary instead of a foreign sales corporation for achieving deferral of U.S. tax on export income. The intercompany pricing rule is by far the more important element.
\item[129.] The Committee Explanation indicates that indirect expenses of both parent and DISC may be attributed to the export sale in accordance with principles applicable under I.R.C. § 861 for determining the source of income of a single entity operating in two countries. Generally, the allocation of indirect expense is made on the basis of the ratio of combined gross income from the particular export sale to total gross income of the related entities. Committee Explanation, supra note 6, at 107-08.
\item[130.] The Secretary is given authority to issue regulations which will establish similar allocation formulae for commission, rental or other income. I.R.C. § 994(b).
\end{itemize}
the intercompany transfer price need not even equal the amount actually charged. Treasury regulations will have to clarify this point, but the initial indication is that adjustments will be allowed after the close of the taxable year to bring the price actually charged into line with the price determined under the intercompany pricing rules.\footnote{131}

Under the first rule (see \textit{Example A} below), the DISC's share of the combined profit is 4\% of the export sales price plus 10\% of the export promotion expense incurred by the DISC in making the sale. The second rule (see \textit{Example B} below) allows the DISC to earn 50\% of the combined profit plus 10\% of the export promotion expenses so incurred. Export promotion expenses include all the ordinary and necessary expenses of carrying on the export business, such as salaries, advertising and warehousing, as well as half the cost of voluntarily utilizing domestic ships and airplanes. It is anticipated that increasing the DISC's share of the combined profit by 10\% of these expenses will encourage the transfer of most selling functions to the DISC and that a greater export sales effort will be generated.

The operation of these intercompany pricing rules will be illustrated by the following series of examples. Three aspects of the pricing rules should be kept in mind. First, the intercompany pricing rules apply only to the sale of export property by a related supplier to the DISC.\footnote{132} (For convenience, the related supplier will be referred to as the parent corporation, although this need not be the case.) Second, the intercompany pricing rules cannot be used to generate an artificial loss to the parent, i.e., no more than 100\% of the combined profit may be allocated to the DISC.\footnote{133} Finally, if an arms length allocation of the combined profit under Section 482 legitimately would allocate a greater share of the combined profit to the DISC, the arms length allocation may be used, but the allocation will be subject to scrutiny by the IRS.\footnote{134}

\textbf{\textit{Example A:}} The 4\% Intercompany Pricing Rule

\begin{tabular}{ll}
\hline
Combined profit: & \\
(1) Export sales price received by DISC & $10,000 \\
(2) Less: cost of goods sold and other expenses & \\
(a) Export promotion expenses incurred by DISC & $1,000 \\
\hline
\end{tabular}

\begin{footnotesize}
\footnotetext{131}{U.S. \textsc{Treasury Department}, \textsc{Handbook for Exporters: DISC,} at 25 (1972).}
\footnotetext{132}{I.R.C. § 994(a). \textsc{Committee Explanation, supra} note 6, at 108.}
\footnotetext{133}{\textsc{Committee Explanation, supra} note 6, at 107.}
\footnotetext{134}{I.R.C. § 994(a) (3).}
\end{footnotesize}
(b) other selling expenses incurred by DISC 800
(c) cost of goods and other direct and indirect expenses incurred by the parent 7,500 — 9,300

(3) Combined Profit

$ 700

DISC’s share of combined profit:
(1) 4% of the export selling price (4% × $10,000) $ 400
(2) Plus: 10% of the export promotion expenses (10% × $1,000) 100
(3) DISC’s share of combined profit $ 500

Intercompany transfer price:
(1) Export sales price received by DISC $10,000
(2) Less: DISC’s share of proceeds of export sale
   (a) export promotion expenses incurred by DISC $ 1,000
   (b) other selling expenses incurred by DISC 800
   (c) DISC’s share of combined profit 500 2,300
(3) Intercompany transfer price $ 7,700*

* This intercompany transfer price will allocate $200 of the combined profit to the parent corporation ($7,700 — 7,500). Note that in determining the combined profit, it is immaterial which entity incurred the expenses. However, it is important for purposes of allocating the combined profit that the DISC incur as much of the export promotion expense attributable to the sale as is possible.

Example B: The 50-50 Intercompany Pricing Rule
Assume that the only difference in computing the combined profit is that the cost of goods sold and other expenses incurred by the parent is $6,500 instead of $7,500 and that other figures remain the same as in the previous example.

Combined profit:
(1) Export sales price received by DISC $10,000
(2) Less: cost of goods and other expenses
   (a) export promotion expenses incurred by DISC $ 1,000
   (b) other selling expenses incurred by DISC 800
   (c) cost of goods and other direct and indirect expenses incurred by parent 6,500 — 8,300
(3) Combined profit $ 1,700

DISC’s share of combined profit:
(1) 50% of combined profit (50% × $1,700) $ 850
(2) Plus: 10% of export promotion expenses (10% × $1,000) 100
(3) DISC’s share of combined profit $ 950

Intercompany transfer price:
(1) Export selling price received by DISC $10,000
(2) Less: DISC’s share of proceeds from export sale
   (a) export promotion expenses incurred by DISC $ 1,000
   (b) other selling expenses incurred by DISC 800
   (c) DISC’s share of combined profit 950 — 2,750
(3) Intercompany transfer price $ 7,250*

* This intercompany transfer price will allocate $750 of the combined profit to the parent ($7,250 — 6,500). Note that if the 4% rule had been used, the initial allocation to the DISC would have been $400 (4% × $10,000). Since the 50-50 pricing rule initially allocates $500 of
the combined profit to the DISC (before adjustment for export promotion expenses), this rule is more favorable to the tax favored DISC.

**EXAMPLE C: Selecting the Most Favorable Pricing Rule**

The most favorable intercompany pricing rule in a particular situation may be determined by the following formulae:

Let:  
\[ S = \text{export sales price received by the DISC} \]
\[ E = \text{export promotion expense incurred by the DISC} \]

1. When the combined profit is less than \(0.04S + 0.10E\), use the 4% pricing rule. The maximum 100% of combined profit is allocated to the DISC in this situation. (The 4% rule cannot be used to generate an artificial loss to the parent.)

2. When the combined profit is between \(0.04S + 0.10E\) and \(0.08S\), use the 4% pricing rule. In this range, between 50% and 100% of the combined profit will be allocated to the DISC.

3. When the combined profit is greater than \(0.08S\), use the 50-50 pricing rule, which allocates combined profit equally between the DISC and the related entity.

4. Whenever an arms length allocation would allocate a greater share of the combined profit to the DISC, the arms length allocation may be used. However, the allocation will be subject to IRS scrutiny and export promotion expenses cannot be used to further allocate combined profit to the DISC.

* These formulae are not applicable when marginal costing, discussed below, is used.

Several important aspects of the intercompany pricing rules must await Treasury Department definition. Section 994(b)(2) of the Code directs the Secretary to promulgate regulations for allocating expenditures in computing combined taxable income under the 50-50 intercompany pricing rule when the DISC is "seeking to establish or maintain a market for export property." The Committee Explanation envisions a rather ill-defined concept of product costing under which only the "marginal costs of producing" the export property would be taken into account in determining the combined profit of parent and DISC.\(^{135}\) The effect of marginal costing is to increase the combined profit on an export transaction by allocating all non-marginal production costs to property sold in the domestic market. However, until Treasury Regulations are issued, three crucial questions remain unanswered: which costs are marginal, whether marginal costing will permit a transfer price resulting in a loss to the parent, and how to determine when the DISC is seeking to "establish or maintain" its market.

A second area in need of Treasury clarification is the Committee statement that "[a]lthough both of the pricing rules . . . generally are to be applied on a product-by-product basis, the rules may be applied on the basis of product lines."\(^{136}\)

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\(^{135}\) Committee Explanation, supra note 6, at 108.

\(^{136}\) Id.
an export operation involving the sale to foreign customers of an end product containing two domestically manufactured components. If the components are sold by a DISC to a foreign affiliate for assembly, the price paid must be at arms length. However, the intercompany pricing rules will determine the price between parent and DISC. If the profit margin varies with each component, it may be advantageous to apply different intercompany pricing rules to each component rather than treating the transaction as a single sale. Limited only by the Treasury's definition of "product" and the expense of obtaining detailed cost information, the more sophisticated the parent's cost accounting system, the greater the benefit to be obtained from the intercompany pricing rules.

VI. IMPACT OF THE DISC ON FOREIGN OPERATIONS

The decision of a United States corporation to initiate or expand existing foreign operations will be based upon many factors. For example, the domestic manufacturer's decision to export will depend upon transportation costs, availability of export financing, product marketability in the foreign market, and tariff and trade barriers. The domestic corporation debating between expansion of its United States production facilities and expansion of its foreign facilities must consider factors such as political stability of the foreign nation in which the facilities are to be located, availability and cost of labor, access to raw materials or component parts, access to long term financing, and United States and foreign restrictions on international investment. Clearly one of the most important factors in either decision will be the impact of United States and foreign taxes. This part will examine the role of United States taxation, specifically the DISC, in the basic decisions of the United States corporation engaged in or contemplating foreign operations.

A. PRE-1972 STATUTORY ENTITIES UTILIZED IN FOREIGN OPERATIONS

Discussion of the DISC's effect on foreign operations must be prefaced by a brief sketch of United States taxation of the income of foreign subsidiaries currently utilized by domestic manufacturers to handle foreign sales. Although this is an extremely complex area of the tax law, the discussion must be limited to a cursory survey of only those provisions likely to be affected by the DISC.

Prior to 1962, it was common for domestic corporations to establish foreign subsidiaries for the sole purpose of reducing the
combined effect of United States and foreign taxation. The key to the typical operation was a subsidiary corporation, the "base company," which was incorporated in a country which imposed little or no tax on foreign income, the "tax haven." Exports manufactured in the United States by the parent were sold to the base company for resale to other foreign affiliates. Intercompany pricing techniques were designed to concentrate the bulk of the overall profit in the base company. Since the base company had no activities in the United States, its income escaped United States taxation because the Internal Revenue Code did not tax the foreign income of foreign corporations, even if substantially owned by United States shareholders. Of equal importance was the reduction of foreign taxes of the country in which the sale ultimately was made. The parent thus had the use of the base company's untaxed earnings with which to expand its foreign operations and the deferral could be virtually permanent because United States taxes were not imposed until the earnings were withdrawn by the parent.

In 1962, however, Congress amended the foreign source income provisions of the Code by adding Subpart F. This provision was directed primarily at the artificial stimulation of foreign investment caused by the lightly taxed base company operation. Subpart F applies only to a "controlled foreign corporation" (CFC) which is defined as a foreign corporation at least 50% of which is owned by United States shareholders. If a foreign corporation is so classified, four classes of income are treated as having been constructively distributed to the United States shareholders, even though no actual distributions are made.

For purposes of comparing and correlating Subpart F and the DISC provision, the most important element of the annual constructive distribution is "foreign base company sales income," a form of "Subpart F income" which derives its name from the scheme it was designed to prevent. Foreign base company sales income usually arises from the sale by the CFC of per-

137. I.R.C. §§ 881-82.
138. I.R.C. §§ 951-64.
140. I.R.C. § 957(a). Only United States persons owning 10% or more of the voting power of the foreign corporation are considered "United States shareholders" for purposes of this test. I.R.C. § 951(b).
141. I.R.C. § 951. The most significant element of the constructive distribution is "Subpart F income" defined in I.R.C. § 952.
142. I.R.C. § 954(d).
sonal property purchased from a related person, provided that the product is produced outside the CFC's country of incorporation and is sold for use outside that country. For example, if a CFC were incorporated in Switzerland and handled sales of the parent's United States production to French customers, the income from those sales would be foreign base company sales income because the product was both produced and sold for use outside the country of incorporation, Switzerland. This was the typical pre-1962 base company scheme. On the other hand, Subpart F income is avoided if the parent's domestic production is sold by the CFC for use in Switzerland, its country of incorporation. A very important corollary of the foreign base company sales income definition is that Subpart F income may be avoided on a sale, regardless of destination, if the CFC manufactures the product in its country of incorporation. This provision benefits those corporations sufficiently large to support foreign manufacturing operations and has served as an inducement for United States manufacturers to locate manufacturing facilities overseas. One of the primary purposes of the DISC provision is to neutralize this bias in favor of foreign manufacturing operations.

Even if the income of a CFC falls within Subpart F, there are a number of exceptions which allow the CFC to defer or avoid its impact. For example, if Subpart F income is less than 30% of the gross income of a CFC, then none of its income will be treated as Subpart F income. Also, Subpart F income may be deferred if invested in "less developed" countries and may be avoided completely if the CFC makes a voluntary "minimum distribution" to its shareholders.

143. Related persons generally are persons owning directly or indirectly 50% of the voting power of the CFC. I.R.C. § 954(d) (3).
144. I.R.C. § 954(d). A destination test is used to determine the locus of the sale. Treas. Reg. § 1.954-3(a) (3) (ii) (1964).
145. Manufacturing is defined in Treas. Reg. § 1.954-3(a) (4) (1964). I.R.C. § 954(d) (2) prevents use of branch offices outside the manufacturing CFC's country of incorporation for the purpose of reducing overall foreign taxes on sales to yet another country, i.e., a variant of the pre-1962 base company scheme. See Treas. Reg. § 1.954-3(b) (1) (1964). When applicable, the branch office rule treats the branch as a subsidiary of the CFC, thus classifying income from sales to the third country as foreign base company sales income.
146. COMMITTEE EXPLANATION, supra note 6, at 90.
147. I.R.C. § 955.
149. I.R.C. § 963.
The final exception to Subpart F was the Export Trade Corporation (ETC) defined in Subpart G. However, because its function was somewhat similar to that of the DISC, Congress terminated the ETC when it enacted the DISC provision. The repeal of Subpart G allows an existing ETC to either retain its status or transfer its assets tax-free to a DISC. The shareholders of a controlled foreign corporation which qualified as an ETC obtained a limited tax deferral if earnings were invested in assets related to the export of United States production. It should be noted, however, that because of the complexity of the provision and the limited amount of deferrable income, domestic corporations rarely attempted to qualify their subsidiaries under the ETC provisions.

Another statutory entity available to United States corporations with foreign operations is the Western Hemisphere Trade Corporation (WHTC). There is no deferral of taxation under the WHTC, but a special deduction results in an effective rate of United States tax of 34%. The WHTC must be a domestic corporation which does all of its business, except for incidental purchases, within the nations of the Western Hemisphere. In addition, 95% of its gross income must be derived from sources without the United States. Despite IRS objection, the courts have accepted title passage as the determinant of whether income is derived from sources without the United States. This permits exporters operating exclusively within the United States to comply with the foreign source income requirement by retaining title to the exported goods until they reach the foreign port of desti-

The most serious problems encountered in operating under the WHTC include the danger of accidental disqualification, the danger of a reallocation under Section 482 of the combined profit on sales of goods acquired from related persons, and the uncertainty as to the outer limits of the title passage test, which arguably might be stretched to permit the WHTC to sell throughout the world provided that title passes within the Western Hemisphere.

B. Corporate Structures Utilizing a DISC Subsidiary

Enactment of the DISC provision makes it necessary for most domestic manufacturers, large or small, to evaluate carefully the possibility of entering into or increasing foreign operations. Unfortunately, there are simply too many important variables to permit a generalized statement of the extent to which United States corporations will benefit from the DISC. Among the tax considerations alone, the following variables must be examined with respect to the individual circumstances of the particular corporation:

1. the extent to which a manufacturer with a high profit margin will benefit from the 50-50 intercompany pricing rule;
2. the extent to which a manufacturer with a low profit margin will benefit from the 4% intercompany pricing rule;
3. the dollar amount of export promotion expense involved in a typical export transaction;
4. the functional allocation of combined profit on an arms length basis between the manufacturing function and the selling function;
5. the feasibility of utilizing foreign subsidiaries to avoid Subpart F income;
6. foreign tax rates;
7. the foreign tax credit.

159. Chao, “Substance of the Sale” Test: From the Balanovski Case Up to Date, 48 TAXES 68, 77 (1970). Other statutory entities available to U.S. corporations with operations in particular foreign areas
The following discussion suggests a possible approach to structuring the foreign sales function in a manner which maximizes the United States tax reduction opportunities provided by the DISC provision. The discussion will focus on those factors which are generally uniform, such as the current effective rate of United States tax at various functional allocations between manufacturing and selling. Non-uniform factors, such as the rate of foreign taxes, the corresponding effect on the United States foreign tax credit, and the dollar amount of export promotion expenses, are not considered, although their omission will be noted. Obviously such factors are of equal significance with the more uniform factors and must be carefully considered in reaching a particular decision.

The starting point is the current effective rate of United States tax on the combined profit of each of the related entities participating in an export transaction. Although both the DISC provision and the various methods of avoiding Subpart F involve tax deferral rather than tax exemption, the relatively long term deferral makes the current effective rate a most important factor.

The maximum effective United States tax rate on a parent corporation when the foreign selling function is handled exclusively by a DISC subsidiary is 36% of the combined profit on the export transaction. This maximum rate is in effect when the 50-50 intercompany rule proves most favorable, and is obtained as follows:

**Example D: Maximum Effective Rate of United States Tax**

<table>
<thead>
<tr>
<th>Allocation of combined profit (assume $1,000)</th>
<th>PARENT</th>
<th>DISC</th>
</tr>
</thead>
<tbody>
<tr>
<td>using 50-50 intercompany pricing rule</td>
<td>$500 ↔ $500</td>
<td></td>
</tr>
</tbody>
</table>

| Annual deemed distribution (50% of DISC taxable income is deemed distributed to the parent) | +250 ↔ -250 |

| DISC's tax deferred income | $250 |
| Parent's taxable income | $750 |
| U.S. corporate income tax rate (I.R.C. § 11) | × 48% |
| U.S. tax liability on $1,000 combined profit | $360 |
| Effective U.S. tax rate on combined profit | 36.0% |

The 36% maximum effective rate does not take into consideration two important factors, the foreign tax credit and the further allocation of combined profit to the DISC in the amount of 10% of its export promotion expenses. The foreign tax credit will vary with the rates imposed by foreign countries. Also, include the Possessions Corporation (I.R.C. §§ 931-34) and the China Trade Act Corporation (I.R.C. §§ 941-43).
since only half the current earnings of a DISC are deemed distributed each year, likewise only half the foreign tax credit with respect to foreign taxes paid on DISC income will be allowed to the shareholders. The effect of the foreign tax credit may be further complicated if the foreign country uses profit allocations other than those obtained by the use of the arbitrary intercompany pricing rules.

The effect of export promotion expenses incurred by the DISC on the tax liability may be illustrated by changing Example D to assume that $2,000 in export promotion expense was incurred by the DISC:

**Example E:** Effect of Export Promotion Expense Incurred by the DISC

<table>
<thead>
<tr>
<th>PARENT</th>
<th>DISC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial allocation of combined profit (assume $1,000) using 50-50 intercompany pricing rule</td>
<td>$500 ↔ 500</td>
</tr>
<tr>
<td>Allocation of 10% of export promotion expense (assume $2,000) to DISC</td>
<td>-200 → +200</td>
</tr>
<tr>
<td>Allocation of combined profit</td>
<td>$700 $300</td>
</tr>
<tr>
<td>Annual deemed distribution (50% to parent)</td>
<td>+350 ↔ -350</td>
</tr>
<tr>
<td>DISC's tax deferred income</td>
<td></td>
</tr>
<tr>
<td>Parent's taxable income</td>
<td>$650</td>
</tr>
<tr>
<td>U.S. corporate income tax rate</td>
<td>× 48%</td>
</tr>
<tr>
<td>U.S. tax liability on $1,000 combined profit</td>
<td>$312</td>
</tr>
<tr>
<td>Effective U.S. tax rate on combined profit</td>
<td>31.2%*</td>
</tr>
</tbody>
</table>

* This is not a uniform rate since it will vary according to the dollar amount of export promotion expenses incurred by the DISC.

The effect of allowing the DISC to obtain an additional portion of the combined profit by incurring export promotion expense is to reallocate profit which would otherwise have been taxed to the parent at 48%. However, only half of the profit allocated to the DISC returns to the parent in the annual deemed distribution; therefore the current tax rate on DISC income is 24% (50% × 48%). Since 10% of the dollar amount of export promotion expenses operates to reallocate combined profit, the actual tax saving generated by transferring such expenses to the DISC is 2.4% (10% × 24%) of each dollar transferred, or $24 per $1,000 of expense transferred to the DISC. It is important to note that the effective rate of tax is not reduced by 2.4%, a fact which is evident in comparing Examples D and E, where the difference in rates is 4.8% (36.0% — 31.2%).

The 36% maximum effective United States tax rate is based on the 50-50 intercompany pricing rule, which yields a uniform

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160. The foreign tax credit is discussed in text accompanying notes 123–24 supra.
allocation of combined profit independent of the yield of an arms length allocation. However, there are two situations in which the DISC will obtain more than 50% of the combined profit. First, whenever the 4% intercompany pricing rule is most favorable, the combined profit allocated to the DISC will range between 50% and 100%. Second, when an arms length allocation would yield a greater allocation to the DISC than under either of the intercompany pricing rules, the arms length allocation is used. In contrast to the uniform effective rate produced by the 50-50 intercompany pricing rule, each of the other methods yields an effective rate which depends upon the exact percentage allocation of combined profit. Examples of the effective rates at various allocations of combined profit may be illustrated as follows:

**EXAMPLE F:** Effective U.S. tax rate at various allocation of combined profit resulting from use of 4% intercompany pricing rule or an arms length allocation pursuant to I.R.C. § 482

<table>
<thead>
<tr>
<th>Allocation of Combined Profit</th>
<th>Effective U.S. Tax Rate*</th>
</tr>
</thead>
<tbody>
<tr>
<td>PARENT</td>
<td>DISC</td>
</tr>
<tr>
<td>49%</td>
<td>51%</td>
</tr>
<tr>
<td>40%</td>
<td>60%</td>
</tr>
<tr>
<td>30%</td>
<td>70%</td>
</tr>
<tr>
<td>20%</td>
<td>80%</td>
</tr>
<tr>
<td>10%</td>
<td>90%</td>
</tr>
<tr>
<td>0</td>
<td>100%</td>
</tr>
</tbody>
</table>

* Exclusive of foreign tax credit and effect of export promotion expenses incurred by DISC. Export promotion expenses would reduce the ultimate tax liability only when the intercompany pricing rules of the DISC provision are used to allocate combined profit. The effective rate cannot drop below 24% when the intercompany pricing rules are used because this could result only if the parent was selling at a loss to the DISC, which is prohibited.

The foregoing discussion of effective rates is applicable only where the parent corporation’s selling function was handled exclusively by a DISC subsidiary. However, the interplay of Subpart F, the DISC intercompany pricing rules, and the DISC’s 50% tax deferral may reduce further the effective rate of United States tax if the parent corporation simply interposes a foreign subsidiary between the DISC and the ultimate foreign customer. The foreign subsidiary may be either a controlled foreign corporation (CFC) which is a subsidiary of the parent, or a foreign international sales corporation (FISC) which is a subsidiary of the DISC. Since both the CFC and the FISC are controlled

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161. See text accompanying notes 135-36 supra (EXAMPLE C).
162. Controlled foreign corporations are discussed in text accompanying notes 138-49 supra.
163. The FISC is discussed in text accompanying notes 62-67 supra.
foreign corporations purchasing goods from a related person which were not produced in the country of incorporation, both will be subject to Subpart F unless the subsidiary sells only in its country of incorporation.\textsuperscript{164} To the extent that the FISC is subject to Subpart F, its income each year will be treated as having been constructively distributed to the DISC. Since only 50% of DISC income is taxed to the parent corporation, the FISC may be useful even if it cannot avoid Subpart F. However, since a CFC’s Subpart F income is taxed in full to the parent, the CFC does not reduce the overall effective rate unless it is able to avoid Subpart F. The rate reduction possible by interposing either a FISC or a CFC, assuming neither is subject to Subpart F is illustrated in Example G.

**Example G:** Effective current U.S. tax rate when parent corporation combines a DISC and a FISC or a DISC and a CFC (controlled by parent) to handle export sales, assuming that both foreign subsidiaries are able to avoid Subpart F, e.g., by selling only in their country of incorporation.

1. **Allocation of combined profit (assume $1,000):**
   - Assuming that the manufacturing function accounts for 70% of the combined profit, and that by carefully structuring the activities of the DISC and foreign subsidiary the bulk of the selling function can be concentrated in the foreign subsidiary, assume that an arms length allocation of combined profit will yield:
     - Parent (manufacturing function): 70%
     - DISC (minor part of selling function): 5%
     - FISC or CFC (major part of selling function): 25%

2. **Effective rate of U.S. taxation:**

<table>
<thead>
<tr>
<th>Allocation of combined profit (arms length)</th>
<th>PARENT</th>
<th>DISC</th>
<th>FISC OR CFC</th>
</tr>
</thead>
<tbody>
<tr>
<td>$700 ↔ $50 ↔ $250</td>
<td>$700</td>
<td>$50</td>
<td>$250</td>
</tr>
<tr>
<td>Combined profit of parent and DISC ($700 + $50 = $750), allocated under the 50-50 intercompany pricing rule</td>
<td>$375 ↔ $375*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assuming foreign subsidiaries avoid Subpart F, their income will not be taxed to either the parent or the DISC</td>
<td>$250</td>
<td></td>
<td></td>
</tr>
<tr>
<td>DISC taxable income</td>
<td>$375</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Annual deemed distribution (50% to parent)</td>
<td>+188 ↔ −188</td>
<td></td>
<td></td>
</tr>
<tr>
<td>DISC’s tax deferred income</td>
<td>$187</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Parent’s taxable income</td>
<td>$563</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Parent’s tax liability (48% × $563)</td>
<td>$270</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Effective rate of U.S. tax on combined profit*</td>
<td>27.0%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Excluding effect of export promotion expenses. There is no foreign tax credit in this situation since income subject to foreign taxation is deferred for U.S. tax purposes.

\textsuperscript{164} See text accompanying note 144 supra.
We have seen that the rate on the same transaction would have been 36% if handled exclusively by a DISC (Example D). And if the parent sold exclusively through a CFC which avoided Subpart F, the parent would have been taxed on its manufacturing income at 48% (48% \times \$700 = \$336) or an effective rate of tax on combined profit of 33.6%. Example G indicates the further reduction in effective rate to 27.0% achieved solely by interposing a foreign subsidiary between the DISC and the ultimate foreign buyer.

A less attractive rate reduction is available even if the foreign subsidiary cannot avoid Subpart F, but the reduction is available only to a DISC selling through a FISC. This reduction is shown in Example H, which assumes the same functional allocation between the parties as in Example G.

**Example H:** Effective U.S. tax rate when parent corporation uses both a DISC and a FISC to handle export sales of domestically produced goods, assuming the FISC is subject to Subpart F, e.g., if the FISC sells outside its country of incorporation.

(1) Allocation of combined profit: same as in Example G

(2) Effective rate of U.S. Taxation:

| Allocation of combined profit (arms length) | $700 ← $50 ← $250 |
| Combined profit of parent and DISC ($700 + $50 = $750), allocated under the 50-50 intercompany pricing rule | $375 ← $375 |
| FISC assumed to be subject to Subpart F, thus its income is constructively distributed to the DISC (FISC's parent corporation) | +250 ← -250 |
| DISC's taxable income | $625 |
| Annual deemed distribution (50% to parent) | +312 ← -312 |
| DISC's tax deferred income | $313 |
| Parent's taxable income | $687 |
| Parent's tax liability (48% \times \$687) | $330 |
| Effective rate of U.S. tax on combined profit | 33.0% * |

* Exclusive of effect of foreign tax credit and export promotion expense incurred by the DISC.

In Examples G and H, a transaction which would have been taxed at 36% if handled exclusively by a DISC was taxed at 27% and 33% respectively when a foreign sales subsidiary was interposed between the DISC and the ultimate foreign customer. The crucial step in achieving both rate reductions is the use of the 50-50 intercompany pricing rule to allocate between the parent and the DISC the combined profit which remains after an
arms length allocation to the foreign sales subsidiary. Relative to a transaction handled exclusively by a DISC, the effect of this three-party allocation is to shift a major portion of the DISC's selling income to the FISC or the CFC by use of the initial arms length allocation, followed by the shift of a significant portion of the parent's manufacturing income to the DISC by use of the arbitrary 50-50 intercompany pricing rule.

This manner of allocation may minimize the role of the DISC in the overall export transaction. However, an important consideration in intentionally minimizing the function of the DISC is the corresponding loss of tax savings generated only when export promotion expenses are incurred by the DISC. It is essential in achieving the rate reduction that there be a “sale of export property” by the parent to the DISC. Without this sale, the 50-50 intercompany pricing rule cannot be used to allocate the combined profit remaining after the arms length allocation to the foreign subsidiary. Therefore, it is essential that the “sale” by the parent to the DISC be able to withstand attack on its substance by the IRS. However, the necessary substance may be provided by having the DISC incur more of the export promotion expense. To the extent that incurring such expense adds to the DISC's contribution to the overall transaction, its arms length share of the overall profit will increase. The corresponding detriment to the rate reduction (which is keyed to minimizing the role of the DISC) will be partially or fully offset by the tax savings of $24 per $1,000 of export promotion expense incurred by the DISC. Obviously, a careful balancing will be necessary to maximize the benefits to a particular corporation of the interplay between intercompany pricing rules, export promotion expenses, the DISC's 50% tax deferral and the foreign subsidiary's avoidance of Subpart F.

Example G is most important for planning purposes since it provides the maximum rate reduction and may be accomplished by using a DISC with either a FISC or a CFC. Example G was based on a functional allocation of 70% manufacturing and 30% selling. The computation may be used to construct the

165. I.R.C. § 994 applies the intercompany pricing rules only to sales by a related person to the DISC. Therefore, sales to foreign affiliates must be made at arms length prices and are subject to IRS scrutiny under I.R.C. § 482. See Committee Explanation, supra note 6, at 108.

166. I.R.C. § 994. The “sale” requirement would not be applicable where the DISC sells for the parent on a commission basis. Such transactions will be governed by Treasury regulations.
table in EXAMPLE I, which indicates the comparative effective rates of United States tax at various functional allocations and using various combinations of foreign and domestic subsidiaries to handle the foreign sales function.\textsuperscript{167}

**EXAMPLE I:** Comparison of effective current U.S. tax rate when parent corporation's foreign sales function is handled by: 1) a CFC controlled by the parent corporation; 2) a DISC; or 3) a combination of either a DISC and FISC or a DISC and CFC. The foreign subsidiaries, CFC and FISC, are not subject to Subpart F (e.g., selling is confined to country of incorporation).

<table>
<thead>
<tr>
<th>Functional allocation of combined profit on arms length basis</th>
<th>Effective U.S. tax rate, foreign sales handled by:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Subsidiary</td>
<td>Domestic Subsidiary</td>
</tr>
<tr>
<td>Manufacture Subsidiary CFC Only</td>
<td>Manufacture Subsidiary DISC Only</td>
</tr>
<tr>
<td>-----------------</td>
<td>-----------------</td>
</tr>
<tr>
<td>100% 0%</td>
<td>48.0%</td>
</tr>
<tr>
<td>90% 10%</td>
<td>43.2%</td>
</tr>
<tr>
<td>80% 20%</td>
<td>38.4%</td>
</tr>
<tr>
<td>70% 30%</td>
<td>33.6%</td>
</tr>
<tr>
<td>60% 40%</td>
<td>28.8%</td>
</tr>
<tr>
<td>50% 50%</td>
<td>24.0%</td>
</tr>
<tr>
<td>40% 60%</td>
<td>19.2%</td>
</tr>
<tr>
<td>30% 70%</td>
<td>14.4%</td>
</tr>
<tr>
<td>20% 80%</td>
<td>9.6%</td>
</tr>
<tr>
<td>10% 90%</td>
<td>4.8%</td>
</tr>
<tr>
<td>0% 100%</td>
<td>0.0%</td>
</tr>
</tbody>
</table>

* Selling function structured to allocate DISC a constant 5%; the balance of the selling function is allocated to the foreign subsidiary. Varying the DISC's share of the selling function will raise or lower the effective rate, however, there must be a "sale" of export property by the parent to the DISC. None of the columns consider the effect of foreign tax or credit export promotion expenses incurred by the DISC.

As indicated at the outset of this discussion, there are simply too many variable factors to permit a conclusion as to the "best" way to handle the DISC. **EXAMPLE I** indicates that the combina-

\textsuperscript{167} The rate reduction illustrated in **EXAMPLE H**, using a DISC and a FISC subject to Subpart F may be shown at various functional allocations, the assumptions remaining the same as in **EXAMPLE G**:

<table>
<thead>
<tr>
<th>Functional allocation of combined profit on arms length basis</th>
<th>Effective U.S. rate when selling function handled by DISC alone, or by DISC and FISC subject to Subpart F:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacture Selling</td>
<td>(1) DISC</td>
</tr>
<tr>
<td>-----------------</td>
<td>-----------------</td>
</tr>
<tr>
<td>90% 10%</td>
<td>36.0%</td>
</tr>
<tr>
<td>70% 30%</td>
<td>36.0%</td>
</tr>
<tr>
<td>50% 50%</td>
<td>36.0%</td>
</tr>
<tr>
<td>30% 70%</td>
<td>31.2%</td>
</tr>
<tr>
<td>10% 90%</td>
<td>26.4%</td>
</tr>
</tbody>
</table>

This combination of entities might be helpful to a corporation whose volume did not warrant an elaborate attempt to avoid Subpart F by use of foreign subsidiaries. Consideration in such a case might be given to conceding the applicability of Subpart F, but perhaps taking advantage of the fact that only half of the FISC's Subpart F income is taxable to the parent. The FISC might also provide a means of avoiding foreign taxes if it is established in a "tax haven" as a "base company" in an operation similar to the typical pre-1962 structure.
tion of a DISC with a foreign subsidiary may sometimes produce the lowest effective rate of United States tax. However, to obtain the rate reduction, the tax savings generated by export promotion expenses incurred by the DISC must be sacrificed. The dollar volume of such expenditures may easily generate tax savings which significantly outweigh the savings achieved by the rate reduction. This will tip the balance in favor of exclusive use of the DISC, which again illustrates that the most advantageous structure will depend upon the precise circumstances of the particular corporation.

If it is decided that the most advantageous structure combines a DISC with a foreign subsidiary, the parent then must decide between using a FISC or a CFC. As indicated in EXAMPLE H, the FISC will be more advantageous if the foreign subsidiary is unable to avoid Subpart F. On the other hand, if Subpart F can be avoided, the CFC may provide greater flexibility than the FISC because of the strict limitations placed on the assets which may be owned by a FISC. Since the CFC is not subject to such restrictions, it will be able to utilize its tax deferred earnings more effectively.

Having concluded that in some instances the benefits of the DISC provision are maximized by integrating the DISC into a complex combination of domestic and foreign corporations, a final point must be noted. The proponents of the original DISC proposal contended that the provision would alleviate the competitive disadvantage of small corporations which were unable to create the complex corporate structures devised by larger corporations to minimize Subpart F income from foreign operations. Representative John W. Byrnes described the effect of the original DISC proposal:

In recent years, U.S. tax laws applicable to international business have been formulated with large, multinational corporations in mind. An important consequence of the DISC proposal will be to aid smaller U.S. companies to enter into or increase their export activities without having to resort to complicated foreign structures and highly sophisticated tax planning. To the extent that DISC benefits are maximized by a complex corporate structure, the small manufacturer, although his position is improved, will remain at a competitive disadvantage relative to the larger manufacturer. However, the reduction in

168. See note 64 supra, and accompanying text.
United States tax liability may make the small manufacturer more competitive relative to its foreign competitors.

The foregoing discussion has centered on the foreign sales of domestically produced goods. Another of the prime objectives of the DISC provision is to encourage manufacturers to locate their facilities in the United States rather than overseas. In determining plant location, the manufacturer must weigh the advantage of complete tax deferral available under Subpart F when manufacturing facilities are located overseas against the advantages of the DISC outlined in the foregoing discussion. Again, the numerous variable factors prevent a general conclusion as to whether the DISC provision will in fact encourage manufacturers to locate plants in the United States.

VII. CONCLUSION

The significant influence of the DISC on the pre-1972 statutory scheme with respect to international operations is readily apparent. Existing exporters undoubtedly will utilize the DISC either in combination with or as a replacement for their existing networks of foreign subsidiaries. Manufacturers who have never exported before may find the DISC a useful device in entering into export operations. It seems unfortunate that Congress did not attempt to design an entity which would serve as a complete substitute for the complex corporate structures designed to avoid Subpart F. Instead, it appears that the DISC sometimes will be merely another entity to be integrated into an already complex structure.

To its opponents, the DISC is an unnecessary $170 million windfall to large, profitable exporters. To its proponents, the DISC represents an important means of solving a problem of national concern. Much of the controversy surrounding the DISC was based on the original Treasury Department proposal and must be tempered somewhat by the compromise version finally enacted.

While it was hoped that the DISC statute would avoid the complexity which characterized the existing statutory scheme, the final enactment is lengthy and complex. Although Secretary Connally describes the legislation as "straightforward," the

170. 1970 Hearings, supra note 1 at 504 (statement of John S. Nolan, Acting Assistant Secretary (Tax Policy), U.S. Treasury Dep't).
171. John B. Connally, Secretary of the Treasury, Memorandum to United States Businessmen, Jan. 24, 1972, reprinted in U.S. TREASURY
fact remains that the statute covers 19 pages, incorporates by reference Subpart F, adds six sections to the Internal Revenue Code and amends 13 other sections. Professors Bittker and Eustice have said of Subpart F that "[i]n an effort to cover every contingency, Subpart F reaches and never leaves a lofty plateau of complexity that the Internal Revenue Code had previously attained only in occasional subsections . . ." 172 The comment would seem equally applicable to the DISC provision.173


173. The deterrent effect of the statute's complexity was discounted by John S. Nolan, Deputy Assistant Secretary (Tax Legislation), U.S. Treasury Dep't, who stated:

In an effort to avoid any possible abuse, the drafting increased the complexity over our original proposal. However, it is not so complex in its regular operation to discourage its utilization and I continue to believe firmly that it would have a substantial effect in increasing exports.

Letter of John S. Nolan, April 7, 1971, on file with the MINNESOTA LAW REVIEW, referring to the 1970 House Bill which was not significantly less complex than the final enactment.

Professor Surrey, Assistant Secretary (Tax Policy), U.S. Treasury Dep't, from 1961 to 1969 and an opponent of the DISC provision, agrees with Mr. Nolan that complexity is unlikely to inhibit use of the DISC. As the guest of the Minnesota Law Forum on February 25, 1972, Professor Surrey stated that despite the complaints of the beneficiaries, complexity alone will rarely prevent use of a favorable provision.