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COMMENT

DISC: A CONTINUING DILEMMA

I. INTRODUCTION

Domestic International Sales Corporations (DISCs) have been a topic of controversy since their inception in 1971.¹ They were conceived by the Nixon administration primarily as a tax incentive for United States firms in order to encourage exports to benefit the balance of trade deficit.² Since 1971 several changes have occurred, placing the proponents of DISC in a constant defensive posture. For example, the switch from the gold standard to the floating exchange rate in 1973 raised questions regarding the efficiency of the DISC as an effective mechanism to stabilize the balance of trade. Such concerns moved the Congress in 1976 to alter substantially the DISC provisions³ and to lessen the deferred allowances to DISC corporations. Most recently, efforts were made on behalf of the Carter administration to repeal the DISC provisions. The potential ramifications of repealing DISC legislation are comprehensible only after one examines the evolution of the DISC machinery and its effectiveness as an economic force in the international and domestic markets. This paper will demonstrate that despite persuasive arguments to the contrary, DISC may still be a positive force in the American economy and should not be repealed at the present time.

II. THE EVOLUTION OF DISC

The DISC provisions were enacted in 1971 as an incentive to American firms to remain in the United States, to employ American citizens and to increase their exports to improve the United States balance of payments. The legislation was adopted when the dollar was still based on a gold standard, two years prior to the conversion to a floating exchange rate. It was Congress' intention to remove a disadvantage to all exporting domestic firms which were ineligible for certain tax benefits available to foreign subsidiary corporations. These subsidiaries had the advantage of indefinitely deferring taxation of

¹ Revenue Act of 1971, Pub. L. No. 92-178 (codified in I.R.C. §§ 991-997).

² H.R. Rep. No. 533, 92d Cong., 1st Sess. (1971); S. Rep. No. 437, 92d Cong., 1st Sess. (1971).

³ I.R.C. §§ 991-997.

their income as long as it was kept abroad.⁴ In contrast, domestic corporate income from exports was fully taxable whether the funds were kept abroad or repatriated.⁵ Additionally, other major trading nations provided monetary incentives to encourage their export industries; the enactment of DISC was an effort to place American domestic exporting firms in a more competitive position in the international market.⁶

Under the DISC deferral system, profits are not to be taxed to the corporation, but are instead taxable to its shareholders (often a parent manufacturing corporation) when they are actually distributed or simply "deemed" distributed.⁷ In 1971, Congress saw fit to limit the deferral to fifty percent of the export income of a DISC. As a result, a domestic sales corporation with income predominantly derived (ninety-five percent) from export sales and rentals could defer paying tax on fifty percent of its income if the corporation met the qualifications provided in the Internal Revenue Code.⁸

The typical DISC is a subsidiary of a parent manufacturing corporation. To qualify as a DISC a corporation must have at least ninety-five percent of its gross receipts attributable to export receipts. At least ninety-five percent of its assets must be export assets. It may not have more than one class of stock outstanding. It must have a minimum capital (either par or stated value) of at least \$2,500 on each day of its taxable year and it must elect to be treated as a DISC.⁹

A DISC is strictly a sales corporation, which generally acquires export property from its parent or an affiliated corporation and then sells those goods abroad. Often, a DISC is a "paper corporation," that is, merely a commission agent. Thus, the determination of the taxable income of a DISC is significant because the parent may benefit from the tax deferral. A parent of a DISC can effectively augment its defer-

⁴ There is no explicit statutory rule providing for deferral of tax on foreign source income. It arises out of the basic jurisdictional distribution between domestic and foreign corporations. Deferral of non-repatriated foreign source income can accrue to a domestic taxpayer through ownership of a foreign subsidiary. See I.R.C. §§ 861-864.

⁵ All income to a domestic corporation will be taxed at the corporate level pursuant to I.R.C. § 61 and will again be taxed at the shareholder level upon distribution pursuant to I.R.C. § 301.

⁶ H.R. Rep. No. 533, 92d Cong., 1st Sess. (1971); S. Rep. No. 437, 92d Cong., 1st Sess. (1971).

⁷ It is important to note that such distributions are treated as dividends and are, accordingly, taxed as ordinary income. See I.R.C. §§ 995(b), 316(a), and 301(c). Further, distributions are generally not eligible for the § 243 dividend deduction. Consequently, the revenue cost effect is not as great as might be anticipated.

⁸ I.R.C. § 995.

ral if the combined taxable income of the parent and the DISC from a particular sale or lease of export property is allocated in a manner which will maximize the DISC's income share while minimizing that of the parent. In order to achieve the goal of encouraging exports through DISCs, Congress enacted special intercorporate allocation standards for DISCs which were not as restrictive as the arms-length standard required by the section of the Code concerning the allocation of income and deductions among controlled taxpayers.¹⁰ Two alternative methods are available to DISCs,¹¹ limited only in that these methods may not be applied in such a way as to cause a loss to be recognized to the affiliated corporation in conjunction with a net profit on behalf of the DISC.

Congress has provided that a DISC election is not conclusive as to tax treatment of the concerned corporation indefinitely.¹² DISC status may be lost upon failure to meet the above qualifying standards. Moreover, Congress carefully created a deferral system by providing for recapture of the income deferred when such income ceased to be reinvested in export activities.¹³

Consequently, deferral under the 1971 DISC provisions was limited to fifty percent of the DISC income.¹⁴ The revenue loss to the United States Treasury was \$100 million.¹⁵ In 1974, the Treasury released its first report on DISCs in reference to the year 1972, and determined that the actual cost of DISC was \$250 million annually.¹⁶ This initial report increased opposition to the DISC program. However, the report's true impact is difficult to assess because of vast changes which occurred in 1972 affecting foreign trade.¹⁷ Some analysts interpret the

⁹ I.R.C. § 992.

¹⁰ Section 482 enables the Treasury to look through inter-corporate transactions to see that they are bona fide and that the prices and terms are such as would have been reached between corporations which are not affiliated. The section allows the government to reallocate funds to achieve an arms-length result.

¹¹ I.R.C. § 994(a)(1) and (2).

¹² I.R.C. § 992(b).

¹³ TREAS. REG. § 1.992 (1977).

¹⁴ I.R.C. § 995.

¹⁵ U.S. DEPT. OF THE TREASURY, THE OPERATION AND EFFECT OF DOMESTIC INTERNATIONAL SALES CORPORATION LEGISLATION, 1974 ANNUAL REPORT (1976).

¹⁶ Revenue Act of 1971 § 506.

¹⁷ Opponents of DISC assert that the increase in American exports in the intervening period has been the result of the changed monetary environment brought about by the shift in 1971 to a floating exchange rate and by related changes in the international environment. See J. Gravell, K. Hughes and W. Farb, *The Domestic International Sales Corporation (DISC) and its Effect on U.S. Foreign Trade and*

report as indicating that DISCs had an apparent positive effect on exports, although the full extent of the effect is not readily ascertainable.¹⁸

A second Treasury Report was issued prior to the Tax Reform Act of 1976.¹⁹ Again, the report indicated that the revenue effects of DISCs were greater than originally anticipated. This assessment, however, was still more favorable as to the effect of DISCs on exports. For 1973, export sales of DISCs showed a 32.6 percent growth rate as compared to an overall growth rate of 23.4 percent.²⁰ Although the study noted that the accuracy of such comparisons might be impaired by methodological problems, it is clear that if even a portion of the difference in the export growth rate is attributable to DISCs, the revenues from increased exports could equal or exceed the revenue lost through the deferred taxation of DISC income.

The continued inability to accurately assess the economic benefits of DISCs in the face of a readily ascertainable cost, spurred the movement to alter DISCs in 1976. The Library of Congress Research Service issued an analysis of DISCs and their effect on American foreign trade and domestic unemployment.²¹ The work was based on a continuum, a view of a best case assumption and a worst case assumption. The analysis indicated that DISCs may have had some positive impact on export growth.²² It also stated that DISCs may have had a negative effect on domestic employment.²³ In 1976 analysts attempted to evaluate the effectiveness of DISCs in the context of a floating exchange rate economy. The Congressional Research Service study stated that "today when the dollar exchange rate is floating against the currencies of our major markets and competitors, the DISC does not appear necessary."²⁴

Opponents of DISCs contend that in an environment of floating exchange rates the effect of DISC's excessive investment in American export industries is to put upward pressure on the dollar thereby en-

Unemployment (May 4, 1976) (Library of Congress, Congressional Research Service Multilith 76-92E).

¹⁸ Toan, *Repeal of DISC: Prospects and Consequences*, 4 INT'L J. TAX. 342 (1975).

¹⁹ U.S. DEPT OF THE TREASURY, THE OPERATION AND EFFECT OF THE DOMESTIC INTERNATIONAL SALES CORPORATION LEGISLATION, 1973 ANNUAL REPORT (1975).

²⁰ *Id.*

²¹ J. Gravell, K. Hughes and W. Farb, *supra* note 17.

²² *Id.* at 27.

²³ *Id.* at 25.

²⁴ U.S. DEPT OF THE TREASURY, *supra* note 19.

couraging American imports. In this manner the stimulative effect on the export portion of the balance of trade is offset by the accelerated growth of United States imports.

Responding to these challenges Congress sought to limit the deferral benefits of the DISC form. It concluded that DISC legislation had had a beneficial impact on American exports;²⁵ exports had increased from \$43 billion in 1971 to \$107 billion in 1975. Congress recognized that in addition to the increase attributable to the devaluation of the dollar, a significant portion of the increase should be credited to the DISC program. On the other hand, Congress was faced with the fact that DISCs were increasingly costly in terms of lost revenue. Thus, Congress imposed an incremental rule which further limited the amount of income which could be deferred.²⁶ Under this rule, DISC benefits are granted only to the extent that a firm increases its exports over a base period amount.

The new mechanism works as follows: For the taxable years beginning after 1975, the fifty percent deferral of the earlier law applies only to that fraction of a DISC's taxable income which exceeds the taxable income attributable to adjusted export gross receipts during a base period. In effect, the taxable income of a DISC is divided into two parts. One part, the non-incremental part, equals the taxable income attributable to export gross receipts of the base period; one-half of the period; this part is deemed distributed by the DISC and is currently taxable to its shareholders. The second part, the incremental part, is the excess of the current year's taxable income over the taxable income attributable to export gross receipts of the base period; one half of the incremental portion is deemed distributed and taxed currently to the shareholders while the other half is deferred.²⁷

Although Congress made an admirable attempt to focus DISC benefits on genuine enhancement of American exports, the incremental approach may act as a disincentive to DISC exporters.²⁸ Setting the

²⁵ Senate Finance Committee Report, S. Rep. No. 938, 94th Cong., 2d Sess. (1976).

²⁶ I.R.C. § 995(e).

²⁷ For a fuller explanation see Gourevitch, *DISC's Ability to Defer Tax on Income Restricted by the Tax Reform Act of 1976*, 46 J. OF TAX. 9, (1977).

²⁸ A calendar year DISC newly formed in 1976 will have no base period export gross receipts until 1980 at which time its average base period exports will be its export gross receipts for 1976 divided by four. For 1981, its average base period gross receipts will be the combined export gross receipts for 1976 and 1977 divided by four. This new DISC will receive full DISC benefits, during each of the three successive years. It will not have a base period consisting of four years until 1983. See Gourevitch, *supra* note 27.

base value equal to a fraction of exports during an earlier base period may work inequities in some cases, removing the motivation of some firms to continually escalate their exports. Those whose export markets are growing quickly or whose prices are rising rapidly will be less affected than others. These initial inequities may be somewhat compensated for by the forward movement of the base period in 1981. The 1975 Treasury Report indicates that the 1976 Act decreased the amount of DISC income eligible for deferral and also may have decreased the incentive to expand exports.²⁹ The problem with the modified provisions is that the current year exports enter the base for future calculations; thus, an increment in current exports causes an increase in future base period exports. This process can result in a greater present deferral, but a lesser deferral in the future. One commentator indicates that this potential incentive to abuse DISC deferral in order to maximize the usefulness of DISC deferral in individual instances may be a source of great concern to critics of DISC.³⁰ However, modified DISCs have such a short history that it is not possible to see whether DISC users actually have, or will, slow the expansion of their exports. Therefore, it is still speculative to state that such abuse has occurred.

Despite these restrictions on DISC tax deferral, controversy still surrounds DISC legislation. The Carter administration recommended the repeal of DISC as part of the 1978 tax program. The administration called for a gradual phase-out of DISC deferral, completely ending DISCs in the early 1980's.³¹

III. SHOULD DISCs BE REPEALED?

The opponents of the DISC program view the cost of deferral as unjustifiable. They argue that DISCs fail to fulfill the expectations of Congress and are simply a drain on Treasury resources. Rather than having a positive influence on the balance of trade, it is stated that DISC may have had a negligible, if not negative, effect on the balance of trade because of the exchange rate adjustments. "The balance of payments arguments originally advanced in support of the DISC legislation are substantially weakened under a system of flexible ex-

²⁹ U.S. DEPT. OF THE TREASURY, THE OPERATION AND EFFECT OF THE DOMESTIC INTERNATIONAL SALES CORPORATION LEGISLATION, 1975 ANNUAL REPORT (1977).

³⁰ Gourevitch, *supra* note 27.

³¹ U.S. DEPT. OF THE TREASURY, THE PRESIDENT'S 1978 TAX PROGRAM 275 (Government Printing Office, 1978).

change rates.”³² To the extent that DISC may have stimulated American exports, it may have lessened the depreciation of the dollar. More rapid depreciation would have encouraged the export industry independent of DISCs as American goods would become more desirable in foreign markets. In turn, the growth of domestic imports would have decelerated. The offsetting effect of the appreciation of the dollar against export stimulation by DISCs, reduces import prices. A reduction in import prices leads to increased demand for domestically produced competitive items. Based on these factors, opponents of DISCs have determined that any possible positive effects DISCs may have on the balance of trade are negated by their negative impact on the domestic import industry.³³

A further ramification within the import industry is the negative impact which DISCs may have on domestic employment. Supporters of the DISC program have emphasized that by encouraging domestically produced exports through the parent-subsidiary DISC arrangement, the domestic job market has been stimulated.³⁴ In 1976, the number of jobs attributable to DISCs were estimated between 600,000 and 900,000.³⁵ A rise in exports will surely increase employment in the export sector but, as opponents point out, an increase in a single part of the economy does not necessarily translate into an increase in employment throughout the entire economy. As a corollary to the negative effects within the import market, it is said that the increased employment in the export industry generated by DISCs is offset by the loss of jobs in the disadvantaged import industry. Furthermore, if the affected import industry is a labor intensive one, then the generation of jobs in a possibly less intensive export industry will, in fact, shrink the number of jobs available. There is no method for concluding positively that DISCs have this negative effect on employment. The factors involved in analyzing the relationships between DISC exports, non-DISC exports and imports are numerous and complex, while an increase in employment in the export sector can be measured. This single certainty is apparently sufficient to satisfy supporters of DISCs.³⁶

³² *Id.*

³³ *See, e.g.*, CONG. REC. 1286 (Feb. 6, 1978) (remarks of Sen. Kennedy).

³⁴ 122 CONG. REC. 11194-11200 (daily ed. June 30, 1976) (remarks of Sen. Fanin).

³⁵ *Id.*

³⁶ *Id.*

It is also contended by those who seek repeal of the DISC legislation that it is not clear that DISCs really reduce distortions in trade caused by the import tariffs of other countries. Additionally it is questionable whether DISCs effectively offset the competitive advantage of foreign firms caused by rebates of value-added taxes on exports of foreign countries. Prior to the enactment of DISC legislation, firms with subsidiaries abroad had the advantage of deferral on their foreign income as long as those funds were kept abroad. Further, upon repatriation of those monies, the corporations could offset much of their tax liability through the foreign tax credit. Deferral and the credit enabled American companies overseas to compete in foreign markets. Congress enacted the DISC provisions to enable a domestic corporation to enter the export market and to defer tax on a portion of their income. It was hoped that this would simultaneously encourage firms to remain and to invest in the United States and to allow such firms to enter the foreign market without a competitive disadvantage. It is uncertain whether the deferral benefits of DISCs, in addition to the foreign tax credit, are really necessary to enable American corporations to compete abroad. Although a credible argument can be made that smaller firms could not compete in the export industry without DISC deferral, the vast majority of firms which avail themselves of DISC benefits are the large multinational corporations. "[W]hile the DISC program perversely tends to help those industries that need help least, it also helps least those industries that need help most."³⁷ This subsidy may increase the ability of such firms to compete but it is not necessary to enable these firms to compete in the foreign market.

Supporters of DISCs state that such deferral must be effective vis-à-vis foreign competitors because those nations were threatened sufficiently to charge that DISC laws are an illegal subsidy under the General Agreement on Tariffs and Trade (GATT).³⁸ Proponents of DISCs add that DISCs, whether legal or not, might prove a useful bargaining tool with other GATT nations. This leverage afforded the United States would be lost if Congress unilaterally repealed the legislation. Accordingly, it is argued that DISCs should not be terminated until GATT renders a final decision on the acceptability of

³⁷ THE PRESIDENT'S 1978 TAX PROGRAM, *supra* note 31 at 279.

³⁸ General Agreement on Tariffs and Trade, *done* Oct. 30, 1947, 61 Stat. 143, T.I.A.S. No. 1700, 55 U.N.T.S. 194 [hereinafter cited as GATT]. See S. Rodriguez, *General Agreement on Tariffs and Trade*, 18 HARVARD INT'L L. J. 706 (1977).

DISCs. Until then they are of benefit in negotiations with other countries who may make concessions in return for the repeal of the Revenue Act provision.³⁹ However, the Carter administration feels that "the domestic costs of the DISC program are out of all proportion to the dubious value of DISC as a bargaining chip in international trade negotiations."⁴⁰

At present, the DISC provisions are inordinately complex and some critics have called for simplification of the statute. It is suggested that simplification would make the DISC election more available to smaller firms which cannot afford expensive tax counsel to lead them through the myriad of restrictions and qualifications. The statutory complexity, which requires much expertise to understand, favors the large multinationals which can allocate resources accordingly. Nonetheless, it would be to the advantage of the multinationals that DISC opponents succeed because multinationals have other tax shelters available while small firms may not. Defenders of DISCs state that the provisions should encourage smaller firms to compete in the export market; yet, if the nature of the statute precludes small corporations from doing so, more serious questions are raised as to the necessity of DISC deferral.

The Carter administration raised strong objections to the lenient price allocation formulas available to DISCs. The flexibility of these special rules allows a parent (particularly a large corporation) to manipulate funds to defer part of the parent's income. Such inequity is not tolerated between related corporations in other parts of the Code controlled by the arms-length standards set by section 482.⁴¹ In the 1976 Tax Reform Act, Congress enacted three anti-avoidance rules to help taxpayers resist this temptation. However, the ultimate effectiveness of these rules will depend upon the vigilance of the Secretary of the Treasury. As the incremental approach takes effect, maximizing the tax benefits of those DISCs having low or zero level exports during the base period, the anti-avoidance rules will be called into play. Perhaps a more realistic approach would be to simply require DISCs to comply with section 482. In that manner, consistency might be achieved, lessening the burden on the Secretary and simplifying the regulation of corporations seeking to abuse the DISC affiliation.

³⁹ *Id.* at 276.

⁴⁰ *Id.*

⁴¹ See note 10 *supra*.

Despite the availability of economic analysis of DISCs, there is substantial difficulty in accurately assessing the benefits of DISCs. Nevertheless, it is relatively easy to estimate the monetary cost to the United States Treasury. According to the President's tax program, DISCs cost \$1,390 million in 1975. This cost was substantially reduced in 1976 because of the incremental provisions. Although the 1976 incremental approach reduced the cost of DISCs, it has been said that the true effect of those provisions may be to discourage exporters.⁴² The President further estimated the costs in 1977 and 1978 to be \$1.0 million and \$1.2 million respectively. The cost to the Treasury in monetary terms fails to account for the offsetting benefits provided by DISC. More importantly, the dollar amount does not reflect a complete loss because of the recapture of DISC income at a later time. DISC requires reinvestment of the deferred taxes into the export base. Those DISCs which fail to continue to reinvest those funds are required to repay the deferred taxes. Although this recapture is permitted to be spread out over a period of time there is no doubt that each DISC so disqualified will be held accountable for all deferred income. Thus, although the present cost to the Treasury may be high, it will be recouped in the case of a failure by a DISC to reinvest and bolster the export market. All income previously deferred will be recaptured limited only by a loss due to the present value of such revenues.

Even the most ardent critics admit that DISCs are responsible for at least modest increases in exports.⁴³ In light of the balance of trade deficit which affects the American economy at the present time, it is reasonable to argue that if DISCs may have any effect on the balance, they should not be repealed. There is no conclusive evidence that DISCs are not beneficial to the balance of trade nor that the stimulation of employment in the export industry has reduced employment in the import sector. Additionally, it is significant that a DISC deferral, unlike a deferral generated when a foreign subsidiary fails to repatriate income, encourages investment and production in the United States. If, as the President had proposed, the deferral on non-repatriated income were eliminated, many firms with labor intensive production might return home. The influx of corporations would positively affect the American economy; however, without DISC benefits the incentive to return to the United States would lessen because such corporations would be subject to full taxation. In the absence of DISC legislation,

⁴² See note 28 *supra*.

⁴³ See 1975 ANNUAL REPORT, *supra* note 29.

corporations might find it more profitable to remain abroad where economic conditions might favor the cost of production because they would at least be able to take advantage of the foreign tax credit. Retention of DISCs, particularly with the repeal of the deferral on non-repartiated income, would bring resources back to the United States. Then perhaps, even in monetary terms, the advantages of DISC would more clearly outweigh the costs.

IV. CONCLUSION

Due to the lack of conclusive evidence that DISCs have no positive effect on the American economy, it is reasonable to conclude that DISC legislation should not be repealed. Despite the arguments against DISCs, it is still unclear that the DISC is not a factor in offsetting the balance of trade deficit. Apparently Congress thought it wise to give the DISC program a chance to prove itself; the 1978 tax program, in its final form, rejected the administration's efforts to extinguish DISCs. In its short life of only seven years, the DISC provision has been subject to massive changes and great criticism. The continued existence of this export mechanism may prove to be the necessary stimulant for the United States export industry and it may be useful in GATT negotiations. The facts are not yet in, hence, a decision to repeal DISCs should be indefinitely postponed.

