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TAX PLANNING FOR EXPORT OPERATIONS: USING THE DISC

DONATELLO M. ROSIGNOLI*

The Revenue Act of 1971 amended the Internal Revenue Code of 1954 so as to provide that certain export corporations, termed Domestic International Sales Corporations (DISC), could elect a special tax treatment which would result in a tax incentive for U.S. manufacturers selling their products outside the United States.[1] Generally, this is accomplished by individuals or corporations forming a DISC subsidiary to realize the taxable income resulting from qualifying export sales transactions. Fifty percent (50%) of the DISC's taxable income is then taxed currently to its shareholder(s), while the tax on the remaining 50% is deferred into future taxable years.

QUALIFICATIONS OF A *DISC*

A DISC is a United States corporation which can have either individual or corporate shareholders, which can be both United States persons or foreign persons. In the case of foreign shareholders, however, it is to be noted that any amount which would be distributed or deemed distributed from the accumulated DISC income or any gain which may arise from the disposition of DISC stock will be treated as being effectively connected with the conduct of the trade or business in the United States through a permanent establishment and, therefore, subject to U.S. taxation under normal rules.[2].

To obtain the DISC tax benefits, a subsidiary must meet the following requirements:

(1) It must be incorporated under the laws of any state or the District of Columbia.[3]

(2) At least 95% of its gross receipts must be qualified export receipts.[4] (As hereinafter defined).

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(3) The adjusted basis of its qualified export assets (as hereinafter (defined) at the close of the taxable year must be at least 95% of the sum of the adjusted basis of all of its assets at the close of the taxable year.[5]

(4) The corporation must only have one class of stock outstanding at all times.[6]

(5) The par or stated value of its outstanding common stock must be at least $2,500 on each day of the taxable year.[7]

(6) The corporation must make an election to be treated as a DISC by filing a statement of election with the Internal Revenue Service.[8]

QUALIFIED EXPORT RECEIPTS AND PROPERTY

Qualified export receipts are, by definition, gross receipts (1) from the sale, exchange or other disposition of "export property" and other export assets, (2) for services of rental of export property which is used by the lessee outside of the United States, (3) for services "related and subsidiary" to other transactions in export property, (4) from dividends with respect to stock of related foreign export corporation, (5) from interest on obligations which are qualified export assets, (6) for engineering or architectural services on construction projects located outside the United States and, (7) for the performance of managerial services in furtherance of other qualified export receipts.[9]

With respect to export property, such property must be manufactured, produced, grown or extracted in the United States by a person other than a DISC.[10] Such person will be deemed as being the manufacturer of the product if (1) such person makes a substantial transformation of the property, (2) if such person's operations with respect to the property are substantial in nature and are generally considered to constitute manufacture or production, or (3) if such person adds a substantial value to the property which for this purpose is defined as 20% or more of the cost of goods sold for inventory value.[11]

Export property must be directed to use and consumption or rental in the ordinary course of trade or business by or to a DISC outside of the United States.[12] The destination test is satisfied when the DISC delivers property to a carrier or freight forwarder for delivery outside the United

States regardless of the F.O.B. point or place of passage of title. It does not matter whether the purchaser is a U.S. person or a foreign person or whether the purchaser will be the ultimate user of the property or has merely purchased the property for ultimate resale. If the sale is made to an unrelated DISC, the destination test will be satisfied regardless of whether delivery is to be made in the United States. Should the sale be to a nonrelated person which is not a DISC for delivery in the United States, the destination test is met only if the selling DISC can establish that after the sale there has been no further sale, use or assembly or other processing within the U.S. and that the property is delivered outside the U.S. within one year after the sale by the DISC.[13] The DISC has the burden of proving compliance with the destination test and must do so by providing a copy of the export bill of lading or other method accepted by the Treasury regulations.[14]

Property imported into the U.S., per se, cannot be classified as export property and property which is manufactured in the U.S. but is made with component parts imported into the United States from abroad to a degree exceeding fifty percent of such property's fair market value will not constitute export property for DISC purposes.[15]

Certain types of property by definition can never meet the classification of export property. These types are as follows:

(1) Property leased or rented by a DISC for use by any member of the control'es group which includes the DISC.[16]

(2) Patents, inventions, models, designs, formulas or processes whether or not patented.[17]

(3) Copyrights, other than films, records, tapes or similar reproductions for commercial or home use.[18]

(4) Good will, trademarks, trade brands, franchises or other similar property.[19]

(5) Property which the President of the United States from time to time may deem to be in short supply.[20]

(6) Property which is sold to a related Western Hemisphere trade corporation.[21]

(7) Services, including the written communication of services in any form.[22]

QUALIFIED EXPORT ASSETS[23]

Qualified export assets of a DISC are as follows:

(1) Export property.

(2) Assets used primarily in connection with the sale, lease, rental, storage, handling, transportation, packaging, assembling or servicing of export property; or the performance of engineering, architectural or certain managerial services.

(3) Accounts receivable and evidence of indebtedness stemming from qualified export receipts.

(4) Money, bank deposits, etc. which are reasonably necessary to meet working capital needs.

(5) Obligations arising in connection with producer's loan. (Hereinafter defined).

(6) Stock or securities of a related foreign corporation.

(7) Obligations issued, guaranteed or insured, in whole or in part, by the Export-Import Bank and the F.C.I.A.

(8) Obligations issued by a domestic corporation solely for financing sales of export property pursuant to an agreement with the Export-Import Bank.

(9) Amounts (other than reasonable working capital) on deposit in the United States that are utilized during certain specified periods to acquire qualified export assets.

TYPES OF *DISC*

The law provides for two types of DISCs, both of which afford the same tax deferral opportunities:

(1) *Commission DISC*

This is a DISC which has been granted a sales franchise by its U.S. parent with respect to certain specified exports. As foreign sales are made, the DISC earns a commission from the parent, although, in accordance with a franchise agreement, the orders are solicited and made in the name of the parent, and the parent makes all billings and collections relating

to such foreign sales. The commission is based on certain inter-company pricing rules (discussed below) and generally comprises 100% of the DISC's taxable income.[24]

This type of DISC is quite easy to operate, since it is merely a "paper" company, requiring no employees or separate invoicing, yet it must still meet the minimum requirements outlined above.

(2) *Principal DISC*

This is a DISC which has been granted a sales franchise by its parent. Under the provisions of the franchise agreement, the parent sells the products to be exported to the DISC which, in turn, resells them abroad. Under this agreement, the soliciting must be done in the name of the DISC and the DISC must use separate order forms, although the goods may be shipped directly to the customer without the DISC maintaining an inventory. Of course, if desired, a DISC can maintain an inventory as well as have its own employees in order to accomplish the sales objectives.[25]

INTERCOMPANY PRICING RULES

DISC taxable income resulting from sales of qualified exports by a principal DISC as a result of domestic purchases from unrelated parties is determined under the usual rules for determining taxable profits (gross income from foreign sales less related deductions).

However, the DISC taxable income from sales of export property purchased from related parties in the case of a principal DISC, or DISC taxable income resulting from a commission payable to the DISC, is determined under specific intercompany pricing rules. These rules provide the following three methods for allocating taxable income generated by the foreign sales to the parent and its DISC:

(1) *The 4%-10% Method*[26]

This method provides that DISC taxable income would be equal to 4% of the sales price to the foreign purchasers, plus 10% of export promotional expenses incurred by the DISC.

(2) *The 50%-10% Method*[27]

Under this method, the DISC would be entitled to 50% of the total taxable income on the foreign sales, plus 10% of the export promotional expenses incurred by the DISC.

(3) *The Section 482 Method*[28]

This method provides that taxable income can be allocated to the DISC to the extent the DISC performs a sufficient function to warrant such taxable income on the transaction, and would be essentially equivalent to taxable income it would have earned if it dealt at arm's length with unrelated parties under similar circumstances.

The 4% and 50% methods are "safe haven" methods, which allocate income to the DISC regardless of the substance or function the DISC otherwise performs. The "Section 482" method is based on the substance of the DISC and, accordingly, income can only be allocated to the DISC to the extent the DISC performs a function which warrants such allocation. Accordingly, the 4% and 50% methods are generally used so that the DISC would not require any substance.

TAXATION OF THE *DISC* INCOME

Generally, 50% *of the* DISC's *taxable income* is *taxed currently* as a "deemed dividend" to the stockholders. For example, if a DISC has $200,000 of export earnings, 100% is taxed currently to its shareholders as a dividend and the other $100,000 is eligible for deferral while it is retained by the DISC. Deferral terminates and tax is imposed on the shareholders of the DISC if the deferred earnings are distributed as a dividend or the corporation no longer qualifies as a DISC or if the stock of the DISC is disposed.

Producer's Loans[30]

One of the most important benefits of the DISC legislation is to enable the domestic manufacturer to use under certain circumstances the tax deferred income accummulated in the DISC. One such use can be obtained through a producer's loan, wherein the DISC lends to the parent an amount not greater than its accumulated and untaxed income. There are many restrictions imposed both upon the lender (DISC) and the borrower (parent) which limit the amount of producer's loans which can be made to the parent. Amounts loaned not qualifying as "producer's loans" may be considered constructive dividends taxable to the parent currently.

The following are restrictions imposed on the lender (DISC):

(1) The obligation (producer's loan) must be evidenced by a note or some other proof of indebtedness and must have a stated maturity of not more than five years;[31]

(2) The loan, when aggregated with the unpaid balance of other outstanding producer's loans, may not exceed the accumulated DISC income, i.e., income on which tax has been deferred, at the beginning of the month in which the loan is made;[32]

(3) The loan can only be made to a person engaged in the U.S. manufacturing, producing, growing or extracting export property;[33]

(4) The loan must be designated as a producer's loan.[34]

It is important, therefore, that adequate records be maintained so as not to run afoul of the foregoing restrictions and avoid the conversion of producer's loans into currently taxable dividends.

The restrictions imposed on the borrower, which can limit the amount available to him, are based on the amount of the borrower's assets that are treated as export related. To determine the amount of the assets which are export related, the borrower aggregates the following three items:

(1) His total U.S. investment (adjusted basis at the beginning of his current taxable year) in plant, machinery and equipment and supporting production facilities;[35]

(2) The amount of the borrower's inventory (at the beginning of his current taxable year);[36] and

(3) The borrower's research and development expenditures (whether expensed or capitalized for tax purposes) accumulated in taxable years beginning after December 31, 1971.[37]

The sum of the above items is then multiplied by a percentage determined by dividing the borrower's total export receipts for the three years prior to the current period by the gross receipts from all sources for the same three preceding years.

A further requirement is that a loan to a producer of exports will only qualify as a producer's loan if at the end of the DISC's tax year the amount of the borrower's increase in the adjusted basis of his U.S. plant and equipment and inventory, plus his U.S. expenditures for development during the year, are at least equal to the total of such loans during the year. Accordingly, as the DISC earns income, the parent can treat as a producer's loan that portion of the deferred income which the borrower uses to increase its investment in export related assets.[38]

Another significant restriction in making the producer's loan is the limitation placed on the borrower regarding the amount for foreign investment attributable to a producer's loan (FIAPL). In order to prevent producer's loans from flowing into foreign investments, the tax deferral allowed on the DISC's accumulated income will be terminated to the extent that any of the proceeds of any of the loans are channeled into foreign investments. There are several tests to determine if there have been any FIAPLs, and it should be pointed out that a thorough review should be made of the applicable laws if such an investment is being contemplated. However, the FIAPL restrictions may be avoided if the corporation can obtain adequate financing of its overseas operations by borrowing from foreign sources.[39]

OTHER USES OF ACCUMULATED *DISC* INCOME

As an alternative to the making of producer's loans, a DISC could purchase an undivided interest in the parent's receivables if the DISC does not keep the receivables on its books. The commission paid to a Commission DISC by the parent could be used to pay for an undivided interest in the parent's export receivables. As a result, the parent would have full use of the DISC's cash, and in addition, the undivided interest in the purchased receivables would constitute a qualified export asset for the DISC. As receivables are collected, the factoring agreement could provide that the DISC's collections would automatically be reinvested, which would also constitute a qualified export asset to the DISC.

The DISC could also invest accumulated DISC income in Export-Import Bank Obligations in the U.S., Foreign Credit Insurance Association Obligations and certain domestic corporations organized to finance sales of export property under certain agreements with the Export-Import Bank.

OTHER FACTORS RELATED TO *DISC*

A DISC cannot be included in a consolidated income tax return with its parent but must file its own tax return which is generally due on the 15th day of the 9th month following the close of its taxable year.[40] Should it be anticipated that losses may be incurred on qualified export transactions which are to be made through a DISC, it is important that these transactions be specifically identified and conducted outside the DISC.

It is important to do so because losses taken in a DISC lower the tax deferral available on profitable qualified export transactions of the period and the resulting losses can otherwise be taken in full on the parent's tax return (if a DISC is a subsidiary) with a result of lowering the parent's tax burden for the period.

The year end of the DISC does not have to coincide with its parent's year end. As a result, additional tax benefits may be obtained by having the DISC's fiscal year end on the last day of the month following the close of the parent's fiscal year. For example, since the parent reports the taxable income of the DISC in the year in which or with which the DISC year ends, a 1975 calendar year corporation which has a DISC subsidiary with a January 31, 1976 fiscal year would report the DISC's taxable income on its return for the calendar year 1975, thusly achieving an additional eleven months of tax deferral.

With respect to termination of DISC status, the election can be voluntarily terminated at any time after the first taxable year is in effect, as long as the revocation is made on or before the ninetieth day of the year.[41] DISC status is automatically terminated when the corporation does not qualify as a DISC for a period of five consecutive years,[42] or when it runs afoul of the other prescribed rules. The effect of both types of termination is that the DISC's shareholders will be taxed on the accumulated DISC income at the time the termination becomes effective.[43]

The State of Florida does not tax the income of a DISC, since the income is taxed at the parent corporation's level. A Florida corporation which has elected to be taxed as a DISC is only required to file a Florida income tax return for the first year it qualified as a DISC. This filing is for information purposes only.[44]

CONCLUSION

As can be seen from the foregoing, a domestic corporation which is engaged almost solely in the export business will be certain to qualify as a DISC. Should the export business be conducted in a non-corporate form by a sole proprietorship or a partnership, it will be necessary to organize a corporation since the profits of a DISC are not subject to tax at the DISC level but only at the shareholder level. The incorporation of a business as a DISC will not result in taxation at two levels. Should a corporation or partnership be engaged in manufacturing, it can also organize a

DISC for its export sales. From a practical viewpoint, inasmuch as there are no limitations or requirements as to the number of shareholders of a DISC, and a DISC can handle the export of any number of United States producers whether they be related or unrelated, it could be contemplated that several small producers could arrange among themselves to export through a jointly owned DISC. It can be seen that the use of a DISC can be tantamount to an interest-free loan from the U.S. Government for an indefinite period of one-half of the Federal income tax which would otherwise be payable on the profits allocated to the DISC. Due to the very liberal pricing rules espoused by the DISC regulation, profits which can be deferred can be substantially greater than the selling profits which could actually be derived from export operations. Should export sale activities, however, be carried on in behalf of unrelated manufactures and the selling company must have substantial facilities of personnel outside of the U.S., the tax deferral possibility that can be obtained by the use of a DISC should be compared with those that are available through the use of a foreign based selling company which, under certain circumstances, could generate 100% deferral of currently earned income.

NOTES

[1]P.L. 92-178, Paragraph 501 added Code Sections 991 through 997 to the Internal Revenue Code of 1954 (Code). These sections are applicable to taxable years ending after December 31, 1971, except that a corporation may not be a DISC [as defined in Code Sec. 992(a)] for any taxable year beginning before January 1, 1972.

[2]I.R.C. Sec. 996(g). See also Sec. 871(b)(1) and Sec. 882 (a)(1). However, Sec. 1441(c) and Sec. 1442(a) do not require withholding of U.S. tax by the DISC.

[3]I.R.C. Sec. 992(a).

[4]I.R.C. Sec. 992(a)(1)(A).

[5]I.R.C. Sec. 992(a)(1)(B).

[6]I.R.C. Sec. 992(a)(1)(C).

[7]*Ibid.*

[8]I.R.C. Sec. 992(b). See Rev. Proc. 72-12, I.R.B. 1972-2, 25 for specific requirements of the election statement to be filed.

[9]I.R.C. Sec. 993(a)(1)(A) through (H).

[10]I.R.C. Sec. 993(c)(1)(A). It is to be noted that used property justifies as new property.

[11]Prop. Regs. 1. 993-3(c)(2).

[12]I.R.C. Sec. 993(c)(1)(B).

[13]Prop. Regs. 1. 993-3(d)(2).

[14]Prop. Regs. 1. 933-3(d)(3).

[15]I.R.C. Sec. 993(c)(1)(C). Such a test will be usually made on an item by item basis.

[16]I.R.C. Sec. 993(c)(2)(A).

[17]I.R.C. Sec. 993(c)(2)(B).

[18]*Ibid.*

[19]*Ibid.*

[20]I.R.C. Sec. 993(c)(3). Act Sec. 603 of the Tax Reduction Act of 1975 (P.L. 94-12, 3/29/75) amended I.R.C. Sec. 993 (c)(2), which now also excludes products subject to a depletion allowance and products the export of which is prohibited under Section 4(b) of the Export Administration Act of 1969 [50 U.S.C. App. 2403 (b)].

[21]Prop. Reg. 1. 993-3(a)(4).

[22]Prop. Reg. 1. 993-3(b).

[23]I.R.C. Sec. 993(b)(1) through (9).

[24]I.R.C. Sec. 993(f).

[25]*Ibid.*

[26]I.R.C. Sec. 994(a)(1).

[27]I.R.C. Sec. 994(a)(2).

[28]I.R.C. Sec. 994(a)(3).

[29]I.R.C. Sec. 995 et seq.

[30]I.R.C. Sec. 993(d).

[31]I.R.C. Sec. 993(d)(1)(B).

[32]I.R.C. Sec. 993(d)(1)(A).

[33]I.R.C. Sec. 993(d)(1)(C).

[34]I.R.C. Sec. 993(d)(1)(D).

[35]I.R.C. Sec. 993(d)(2)(A).

[36]I.R.C. Sec. 993(d)(2)(B).

[37]I.R.C. Sec. 993(d)(2)(C).

[38]I.R.C. Sec. 993(d)(3).

[39]I.R.C. Sec. 995(b)(1)(E).

[40]I.R.C. Sec. 1504(b)(7).

[41]I.R.C. Sec. 992(b)(3)(A).

[42]I.R.C. Sec. 992(b)(3)(B).

[43]I.R.C. Sec. 995(b)(2).

[44]Fla. St. Sec. 220.222.