

Use of a Domestic International Sales Corporation to Reduce Federal Income Tax on Export Earnings

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LEGISLATIVE BACKGROUND

The Domestic International Sales Corporation (hereinafter DISC) provisions¹ were introduced into the Internal Revenue Code by the Revenue Act of 1971. The purpose of these provisions was to increase U.S. exports and thereby (1) improve the balance of trade position of the United States which had been deteriorating badly during the late 1960's and early 1970's,² and (2) reduce the

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1. INT. REV. CODE OF 1954, §§ 991-97.

2. The Report of the Senate Finance Committee to accompany the Revenue Act of 1971 noted a trend of decreasing surpluses in the balance of goods and services: \$7.1 billion in 1965, \$2 billion in 1969, and \$3.6 billion in 1970. In the second quarter of 1971, the balance of trade ran a deficit of \$88 million. S. REP. No. 437, 92d Cong., 1st Sess. 7 (1971). While exports had continued to increase during this period, they had not kept pace with the surge of imports. With the exception of a few in-

unemployment rate which had increased significantly during the latter part of this period.³ The method employed to achieve these objectives was a tax incentive for U.S. exporters in the form of the deferral of federal income tax on export income earned by a DISC until such time as the DISC distributed these earnings.

The theory underlying the DISC concept, as proposed by the Treasury Department initially in 1970 and again in 1971, was to neutralize the tax factors affecting a firm's decision to export or manufacture abroad. The Treasury Department had concluded in 1969 that the United States tax system encouraged domestic firms to manufacture abroad by providing deferral of tax on foreign source income earned through foreign subsidiaries.⁴ In contrast, prior to the DISC legislation, firms which engaged in export activities were subject to full U.S. corporate income tax on such export income. Thus, to eliminate the discrimination in the U.S. tax laws against firms exporting through a domestic subsidiary, the Treasury Department proposed a tax deferral on the income of a domestic export subsidiary qualifying as a DISC. In addition, the Treasury was concerned that most other major trading nations provided some form of tax incentive to encourage exports, placing U.S. exporting firms at a competitive disadvantage. Thus, the DISC proposal was also intended to enable U.S. firms to compete abroad for export markets on a more equitable basis with respect to their foreign competitors.

Specifically, the deferral of tax on the income of a DISC was intended to increase exports by enabling firms to translate the tax savings into lower export prices or additional export promotional

dividual months, the U.S. trade balance has remained in a deficit position since the spring of 1971.

3. The Senate Report also noted that the unemployment rate had exceeded 6 percent for much of 1971, and showed no inclination to return to the 4 percent level which represented the generally accepted full employment rate *supra*, at 6. In fact, the unemployment rates during this period were: 1969-3.5 percent, 1970-4.9 percent, 1971-5.9 percent.

4. The Revenue Act of 1962 had limited the extent to which U.S. tax could be deferred on the foreign earnings of controlled foreign corporations of U.S. shareholders by taxing currently certain foreign base company income and foreign earnings invested in the United States. However, foreign subsidiaries manufacturing in the country of their incorporation were not affected by the 1962 Act and could defer U.S. tax on their foreign earnings until such earnings were repatriated to the United States.

efforts. However, as finally enacted, the deferral of tax under the DISC provisions was not made contingent on a showing by the U.S. exporter that its exports had increased over the firm's prior history of export sales during some designated base period.⁵ The Treasury thought that such an approach would be administratively impractical and would create inequities with respect to firms which had made a substantial export effort during the base period.

The DISC provisions were passed by the House of Representatives as part of the Trade Act of 1970. However, the Trade Act, together with the DISC proposal, died in the Senate Finance Committee late in 1970. The DISC provisions were reintroduced in August, 1971, as part of President Nixon's New Economic Policy. This time, with the advent of a major international monetary crisis attributable, to a great extent, to U.S. balance of payments deficits and continuing high unemployment rates, the Congress enacted DISC, but not without two substantial modifications of the Treasury's original proposal: first, deferral was limited to 50 percent of the DISC's income; and second, deferral would be terminated to the extent "producer's loans" made by a DISC to its parent corporation were used to finance foreign investment by the latter. Both modifications were added by the Senate Finance Committee late in the legislative process. However, a Senate provision which would have limited DISC to a 5-year life was deleted by the Conference Committee.

ORGANIZATION OF A DISC

A DISC can be organized by converting an existing corporation into a DISC, or by incorporating a new corporation to qualify as a DISC. An existing corporation will not qualify as a DISC unless it has been operating substantially as an exporting firm; and, in any event, there is no tax advantage in using an existing corporation as a DISC.⁶ Most manufacturing firms have established new

5. In fact, the House of Representatives had passed the DISC legislation based on an incremental approach, making tax deferral available only to the extent a company's export income exceeds 75 percent of its average export income in the years 1968 through 1970. The Senate rejected the incremental approach in favor of a 50 percent limit on the amount of the DISC's income subject to deferral, and the Conference Committee followed the Senate version.

6. As noted below, *see* text at note 32, *infra*, combination export managers and export subsidiaries of manufacturing companies could be used to qualify as a DISC without having to organize a new corporation for this purpose. However, in most cases it will be necessary to transfer assets and employees from an existing corporation to qualify it as a DISC in view of the 95 percent gross receipts test and assets test described later.

corporations to qualify as a DISC, and in the discussion which follows, it will be assumed that a new corporation will be used.

Domestic Corporation

A DISC must be a corporation which is incorporated under the laws of any state or the District of Columbia.⁷ An association cannot qualify as a DISC even if it is taxable as a corporation pursuant to section 77.01(a)(3) of the Internal Revenue Code (I.R.C.). In addition, neither a corporation created or organized under the laws of a possession of the United States nor the Commonwealth of Puerto Rico can qualify as a DISC.⁸ The words "Domestic International Sales Corporation" or "DISC" need not appear in the name of the corporation, and no special requirements are applicable with respect to its certificate of incorporation.

Certain domestic corporations subject to special tax treatment under the Code are ineligible to be treated as DISCs.⁹ These include tax-exempt organizations, personal holding companies, certain financial institutions, insurance companies, regulated investment companies, and Subchapter S corporations. However, this restriction would not appear to preclude these corporations from owning stock in a DISC or having a subsidiary which qualified as a DISC.

Capital Stock

A DISC can have only one class of stock, and the par value (or in the case of no-par stock, the stated value) of the corporation's outstanding stock must be at least \$2,500 on each day of the taxable year.¹⁰ This last requirement, which was intended to facilitate the establishment of a DISC, created many problems during the early stages of the DISC program because it was not practical to capi-

Thus, it would be less expensive to incorporate a new corporation to qualify as a DISC or use a "shelf" corporation which has never been activated.

7. INT. REV. CODE OF 1954, § 992(a)(1); Proposed Treas. Reg. § 1.992-1(a)(1). In selecting the place of incorporation as well as the corporate shareholder of a DISC, consideration should be given to the applicable state tax treatment of DISCs, since state tax laws vary considerably in this regard.

8. See Proposed Treas. Reg. § 1.992-1(a), 37 Fed. Reg. 10368 (1972).

9. INT. REV. CODE OF 1954, § 992(d).

10. INT. REV. CODE OF 1954, § 992(a)(1)(C).

talize a corporation with \$2,500 on the very first day of its legal existence. Accordingly, the proposed regulations liberalized this rule and now permit \$2,500 of cash or property to be paid into the DISC at any time before the expiration of the period for making the DISC election.¹¹

The proposed regulations also provide special rules for determining when purported debt of a DISC will be recognized as such or treated as stock. This distinction is important even though the DISC is not a taxpaying entity, because purported debt could constitute a second class of stock. In general, these regulations represent a liberalization of the traditional stock versus debt rules, and allow the shareholder of a DISC to rely on the formal indicia of an indebtedness.¹² The proposed regulations also provide guidance for determining when stock with different rights, or debt which is treated as stock, will be considered a second class of stock.¹³

DISC Election

The rules governing the filing of a DISC election were originally contained in Revenue Procedure 72-12,¹⁴ but are now set forth in the proposed regulations.¹⁵ The election to be treated as a DISC, which is made by the DISC itself rather than its shareholder, can be filed on Form 4876 at any time within 90 days after the beginning of the DISC's first taxable year. If a corporation does not elect to be treated as a DISC for its first taxable year, the election must be made during the 90-day period immediately preceding the first day of the subsequent taxable year for which the corporation elects to be treated as a DISC. Shareholder consents must be filed by each person who is a shareholder of the DISC as of the beginning of the first taxable year for which the election is effective. The consent can be set forth on Form 4876 or can be made in a separate statement attached to such Form.¹⁶

Once a DISC election is made, it remains in effect until it is revoked by the corporation or the corporation fails to qualify as a DISC for five consecutive years.¹⁷ Thus, if a corporation which has made a valid DISC election fails to qualify as a DISC for a

11. Proposed Treas. Reg. § 1.992-1(d)(1).

12. Proposed Treas. Reg. § 1.992-1(d)(2).

13. Proposed Treas. Reg. § 1.992-1(d)(3).

14. 1972 INT. REV. BULL. No. 2 at 25-26.

15. Proposed Treas. Reg. § 1.992-2.

16. The Instructions to Form 4876 contain a different rule with respect to the manner of filing shareholder consents, but the proposed regulations, which are subsequent in time, would prevail.

17. INT. REV. CODE OF 1954, §§ 992(b)(2)-(3).

particular taxable year, it will remain a DISC for subsequent taxable years without having to make a new election.¹⁸ However, as discussed below, by failing to qualify as a DISC for a particular taxable year, the corporation's accumulated DISC income will be subject to tax in the hands of the DISC's shareholder.

Taxable Year of the DISC

Even though a DISC is not a tax-paying entity, it is necessary to know its taxable year for purposes of applying the 95 percent gross receipts and assets tests, and for determining the date on which its shareholder is considered to receive a "deemed distribution." The proposed regulations provide that a DISC may choose any taxable year without regard to the taxable year of its shareholder.¹⁹ The election form, Form 4876, has a space for indicating the DISC's taxable year. However, the Internal Revenue Service has announced that if the DISC's taxable year has not been selected at the time of filing the election, this may be so indicated on Form 4876.²⁰ Moreover, the Service has ruled that a DISC is not bound by the taxable year specified on Form 4876 and may use a different date for its first taxable year when it files its annual return on Form 1120-DISC.²¹ However, once a DISC has selected a taxable year on its Form 1120-DISC, it can only change such year with the consent of the Commissioner of Internal Revenue, pursuant to section 442 of the Code.

18. Moreover, a corporation which files an annual return on Form 1120-DISC will be treated as a DISC for certain purposes even though it fails to meet the requirements of a DISC for that taxable year. See Proposed Treas. Reg. § 1.992-1(g).

19. Proposed Treas. Reg. § 1.991-1(b)(3)(i). Thus, many taxpayers have decided to put their DISC on a taxable year which ends one month after the end of its parent's taxable year in order to maximize tax deferral. For example, if a parent corporation is on a calendar year 1972 and puts its DISC on a taxable year ending January 31, 1973, the 50 percent "deemed distribution" to the parent described below will not have to be taken into the parent's gross income until 1973 and tax will not have to be paid until September 15, 1974; (assuming the proper extensions have been filed by the parent and that the deemed distribution from the DISC need not be taken into account for estimated tax purposes).

20. TECH. INFO. REL. 1186, July 31, 1972.

21. Rev. Rul. 73-81, 1973 INT. REV. BULL. No. 7 at 33. Moreover, the ruling indicates that the adoption of a different taxable year on the DISC's annual return will not invalidate the DISC election previously filed.

Franchise Agreement

If a DISC intends to deal with or act on behalf of a related person, it should enter into a written franchise agreement with such related person as soon after incorporation as possible. A written franchise agreement is required under the proposed regulations before the intercompany pricing rules discussed below can apply to a DISC in determining its taxable income.²² Moreover, the proposed regulations provide that the franchise agreement must be executed *prior* to any transaction to which the intercompany pricing rules will apply.²³

The proposed regulations do not specify any form for the franchise agreement except that the agreement must provide for "determination of the price payable by the DISC, or the commission payable to the DISC." This amount can be stated as the maximum amount allowed under the intercompany pricing rules provided at section 994(a) of the Code. The franchise agreement should be nonexclusive so that the DISC need not be involved in a transaction which would produce nonqualified export receipts, or, in certain loss situations, where the DISC tax benefits cannot be used.

Ownership of a DISC

There are no restrictions on the type of person who may organize and own a DISC. A DISC's shareholder can be an individual, a partnership, an estate, a trust or a corporation. Its shareholder can be a domestic or foreign person.²⁴ Moreover, a tax exempt organization's status will not be adversely affected by ownership of stock in a DISC.²⁵ However, a domestic corporation will not be eligible for the tax benefits of a Western Hemisphere

22. Proposed Treas. Reg. § 1.993-1(l). See also Rev. Rul. 72-166, 1972 INT. REV. BULL. No. 15, at 17.

23. The regulations as originally proposed would have applied this requirement retroactively to January 1, 1972. In response to widespread criticism, the Treasury amended the proposed regulations with respect to transactions entered into before April 9, 1972, so that the written franchise agreement for such transactions could be executed at any time prior to April 9, 1973. However, with respect to transactions entered into on or after April 9, 1973, the written franchise agreement must be executed prior to the transaction or else the DISC's taxable income will be determined under the section 482 regulations.

24. If the DISC's shareholder is a foreign person, special rules apply in determining the character of distributions, actual and deemed, received by the foreign shareholder from the DISC. INT. REV. CODE OF 1954, § 996(g).

25. Rev. Rul. 73-247, 1973 INT. REV. BULL. No. 23 at 9. Presumably, this ruling would apply to any organization exempt from tax under section 501(c), and not just farmers' cooperative associations exempt under section 521. But see INT. REV. CODE OF 1954, § 992(d) (1).

Trade Corporation or a "possessions corporation" if it acquires stock in a DISC.²⁶ While not entirely clear, it would appear that a corporation which is ineligible to elect to become a DISC under I.R.C. section 992(d) may nevertheless own stock in a DISC.

OPERATION OF A DISC

Once a corporation has been organized in the manner described above and has made a timely DISC election, it can qualify as a DISC for the taxable year provided:

- (1) 95 percent of its gross receipts for the year consist of qualified export receipts (the "95 percent gross receipts test");
- (2) 95 percent of the adjusted basis of its assets at the close of its taxable year consist of qualified export assets (the "95 percent assets test");
- (3) it has its own bank account; and
- (4) it maintains separate books and records.²⁷

Aside from the gross receipts test and the assets test, which are described in greater detail below, none of the requirements necessary to organize and operate a DISC should present any difficulties. In fact, one of the principal features of the DISC legislation is the relative ease with which a DISC can be organized and operated. For example, from the inception of the DISC program, the Treasury has made it clear that the ordinary rules of corporate substance will not apply to a DISC.²⁸ Thus, proposed Regulation Section 1.992-1 (a) provides:

A corporation which satisfies the requirements described [above] for a taxable year is treated as a separate corporation for Federal tax purposes and qualifies as a DISC, even though such corporation would not be treated (if it were not a DISC) as a corporate entity for Federal income tax purposes . . . The rules contained in this paragraph constitute a relaxation of the general rules of corporate substance otherwise applicable under the Code.²⁹

In fact, if the taxpayer so elects, a DISC can be operated as a paper company, being used principally as an accounting device for meas-

26. INT. REV. CODE OF 1954 §§ 922, 931 (a).

27. Proposed Treas. Reg. § 1.992-1 (a).

28. Rev. Rul. 72-166, 1972 INT. REV. BULL., No. 15 at 17, now substantially set forth in Proposed Treas. Reg. § 1.993-1 (l).

29. There is ample authority in the legislative history of the DISC provisions for this approach. H.R. Rep. No. 533, 92d Cong., 1st Sess. 60; S. Rep. No. 437, *supra* note 2, at 93.

uring the amount of export earnings subject to tax deferral. The Treasury Department has recognized this aspect of the nature of a DISC by stating in its proposed regulations:

The separate incorporation of a DISC is required under section 992(a)(1) to make it possible to keep a better record of the income which is subject to the special treatment provided by sections 991 through 996, but this does not necessitate in all other respects the separate relationships which otherwise would be required between a parent corporation and its subsidiary.³⁰

If a DISC is to be operated with a minimum of corporate substance, the most suitable form of operation is for it to receive a commission from its shareholder based on the special intercompany pricing rules contained in I.R.C. section 994 (a "commission DISC"). This type of operation has the advantage of keeping the expenses and administrative difficulties of operating a DISC at a minimum. The Treasury has given an example in the proposed regulations of how a commission DISC can be operated as essentially a paper company.³¹ In this example, all the normal functions of a commission agent are performed by the employees of the DISC's parent in the parent's own name, *i.e.*, solicitation of orders, billings and collections. The DISC has no functions except to enter into a written franchise agreement with its parent and to receive commissions determined under the pricing rules of section 994.³²

On the other hand, there are situations in which it would be desirable to use a company with its own office and its own employees as the DISC.³³ For example, a combination export manager may want to elect to treat itself as a DISC rather than establish a separate subsidiary to qualify as a DISC. In addition, where a manufacturing corporation already has a separate export company whose sole activity is the performance of export sales functions, the export subsidiary could elect to be treated as a DISC. In such cases, the corporation electing to be treated as a DISC could

30. Proposed Treas. Reg. § 1.992-1(a).

31. Proposed Treas. Reg. § 1.993-1(l)(4) Example (2).

32. As indicated in Proposed Treas. Reg. § 1.993-1(l)(4) Example (1), a paper DISC can also be operated on a resale basis. However, there is no advantage in this method of operating since the DISC's parent is required to solicit orders, bill, etc., in the name of the DISC subsidiary which may be inconvenient and, in any event, can be avoided by using a commission DISC. Use of a commission DISC also enables the parent to avoid duplicate sets of books and records for accounts receivable and sales income.

33. There are also certain limited tax advantages in that a DISC with corporate substance will be entitled to more "export promotion expenses" which, as described below, will increase the amount of income subject to deferral under the section 992 intercompany pricing rules. See text at notes 85-90, *infra*.

operate either as a commission DISC or on a resale basis ("buy-sell DISC"), depending on its existing method of doing business. However, in most cases where the taxpayer does not already have a separate corporation which will qualify as a DISC, it would be advisable to organize a new corporation and operate it as a paper company on a commission basis in order to keep administrative expenses at a minimum and to avoid disrupting present corporate arrangements by transferring the exporting functions to a separate subsidiary corporation.

TYPE OF INCOME A DISC MAY EARN

I.R.C. section 992(a)(1)(A) provides that to qualify as a DISC for a taxable year, 95 percent of a corporation's gross receipts must consist of qualified export receipts.³⁴ The definition of qualified export receipts set forth in section 993(a)(1) was intended to limit DISC benefits to receipts from the sale or lease of export property and export related transactions. Except in certain specific instances described below, service income was excluded from qualified export receipts and thus from the DISC provisions. The exclusion of most forms of service income from the DISC proposal was attributable to the Treasury's desire to limit the revenue losses arising from the DISC legislation. The Treasury had not found the same compelling need to remove competitive disadvantages for the service industries as it had found in the case of U.S. exporters of tangible personal property. Moreover, in the view of the Treasury, the service industries were not faced with the same choice of where to conduct their activities so that the extension of DISC benefits would have less of an impact than in the case of exporters of goods.³⁵

Exceptions were made, however, for services which are related and subsidiary to an export transaction, engineering and architectural services for construction projects located abroad, and man-

34. In the case of a commission DISC, gross receipts include the gross receipts derived by the principal from the sale or lease of the property, or the gross income derived by the principal from the furnishing of services, with respect to which the DISC's commissions are derived. INT. REV. CODE OF 1954, § 993(f); Proposed Treas. Reg. § 1.993-6(e).

35. Patrick, *Domestic International Sales Corporation (DISC)—The 1971 Legislation*, PRIVATE INVESTORS ABROAD—PROBLEMS AND SOLUTIONS IN INTERNATIONAL BUSINESS IN 1972 at 327 (1972).

agerial services for other DISCs, since it was thought that these types of services indirectly contributed to increased exports of tangible property.³⁶ Where a specific exception for a category of service income is not applicable, the Service has made it clear, through several published rulings, that such income will not be entitled to tax deferral under the DISC provisions.³⁷

In addition, royalties from the use of intangible property abroad were excluded from the DISC proposal,³⁸ notwithstanding the substantial positive contribution of these receipts to the U.S. balance of payments. The Treasury's reasoning was that export sales produced a greater positive effect on the balance of payments, and that licensing to foreign manufacturers resulted in loss of U.S. jobs.³⁹ However, royalties from films, tapes and records were not covered by the exclusion, and thus can be earned by a DISC or its principal. Moreover, receipts on the sale of a copyrighted article, such as a book, will qualify for DISC benefits, as distinguished from royalties from the use of the copyright to manufacture the book outside the United States.⁴⁰

Sale or Lease of Export Property

As indicated above, the primary source of a DISC's income will be receipts from the sale or lease of export property. The meaning of the term "export property" is central to the DISC provisions, for it defines the type of activities a DISC may conduct and the type of transaction which will be considered an export for DISC purposes. Property will be considered export property if it meets the following six requirements:

(a) The property must be manufactured, produced, grown or extracted in the United States by someone other than a DISC.⁴¹ Since a DISC cannot engage in manufacturing operations, it must be a sales organization or a commission agent for a manufacturer

36. For example, it was considered likely that a foreign construction project using U.S. engineers or architects would obtain a substantial portion of its materials and equipment from the United States.

37. Rev. Rul. 72-548, 1972 INT. REV. BULL. No. 46, at 38 (management consultant); Rev. Rul. 72-580, 1972 INT. REV. BULL. No. 49 at 10 (freight forwarder); Rev. Rul. 73-228, 1973 INT. REV. BULL. No. 21 at 10 (purchasing agent); Proposed Treas. Reg. § 1.993-3(b).

38. INT. REV. CODE OF 1954, § 993(c)(2)(B).

39. Patrick, *supra* note 35, at 328.

40. Proposed Treas. Reg. § 1.993-3(f)(3).

41. INT. REV. CODE OF 1954, § 993(c)(1)(A). The proposed regulations provide three alternate tests for defining a manufacturing process, including substantial transformation of the property. Proposed Treas. Reg. § 1.993-3(c)(2); Rev. Rul. 73-279, 1973, INT. REV. BULL. No. 26 at 15.

which has its own sales divisions. The manufacturer need not be related to the DISC, although in most cases it will be.

(b) Export property must be sold or leased for direct use, consumption or disposition outside the United States.⁴² This requirement, referred to as the "destination test" in the proposed regulations, is generally satisfied by delivery of the property sold or leased to a carrier within the United States for ultimate delivery abroad, or by delivery directly to the purchaser or lessee at a point outside the United States.⁴³ Intermediate delivery within the United States is permitted if the purchaser or lessee is an unrelated DISC, or if the property is reshipped by the U.S. purchaser or lessee within one year without further use, manufacture or assembly within the United States.⁴⁴ The place where title passes is not relevant in applying the destination test to property sold or leased by a DISC.

The means of proving compliance with the destination test are set forth in the proposed regulations.⁴⁵ Generally, an export bill of lading, a certificate of an agent of the carrier disclosing delivery of the property outside the United States, or a shipper's declaration will be sufficient. In Revenue Ruling 73-70,⁴⁶ the Service indicated that it was permissible to delete the price and ultimate consignee's name from the export documents. However, if the DISC fails to provide proof of compliance with the destination test as provided in the proposed regulations, the property sold or leased cannot qualify as export property.⁴⁷

42. INT. REV. CODE OF 1954, § 993(c) (1) (B).

43. Proposed Treas. Reg. § 1.993-3(d) (2). Export property may be delivered directly to the foreign purchaser or lessee by the seller or lessor's own carrier or from the seller or lessor's warehouse located abroad. Used property can qualify as export property if it is located in the United States at the time of its sale or lease. Rev. Rul. 72-455, 1972 INT. REV. BULL. No. 39 at 33. With respect to the sale or lease of used property located outside the United States, see Proposed Treas. Reg. § 1.993-3(d) (2) (vi).

44. Proposed Treas. Reg. § 1.993-3(d) (2); Rev. Rul. 73-229, 1973 INT. REV. BULL. No. 21 at 10. Thus, export property could be sold through a domestic sales subsidiary of a domestic manufacturer where the manufacturer acts as the parent and principal of the DISC. See Proposed Treas. Reg. § 1.993-3(d) (2) (ii).

45. Proposed Treas. Reg. § 1.993-3(d) (3).

46. 1973 INT. REV. BULL. No. 6 at 23.

47. Proposed Treas. Reg. § 1.993-3(d) (3) (iii).

(c) Property sold or leased by a DISC will not qualify as export property if more than 50 percent of the fair market value of such property is attributable to articles imported into the United States.⁴⁸ The fair market value of imported articles is their appraised value under the customs laws at the time of their import into the United States.⁴⁹ An article will be treated in its entirety as an imported article even if all or a portion of such article was originally manufactured or produced within the United States.

(d) Property will not qualify as export property if it is sold or leased for ultimate use within the United States.⁵⁰ The principal problem here concerns sale or lease to unrelated persons. The proposed regulations take a flexible approach with respect to sales of property to unrelated persons by providing that such property will be considered sold for ultimate use in the United States if (i) there is an agreement or understanding for such use in the U.S., or (ii) a reasonable person would have believed that the property would be used in the U.S. Moreover, sales of components to unrelated persons will in no event be considered sold for ultimate use in the United States if the components constitute less than 20 percent of the fair market value of the finished product. A different standard applies to leases, however, where the lessor is apparently accountable for the lessee's use of the leased property, regardless of his knowledge or belief at the beginning of or during the term of the lease.

(e) Property leased to a person who is a member of the same controlled group of corporations as the lessor will qualify as export property only if it is subleased by such member to an unrelated third party who uses the property outside the United States.⁵¹ However, property sold to a related person can qualify as export property provided the related purchaser is not a DISC⁵², and the sale meets the destination test described above.

(f) Property which is sold or leased by a DISC or its principal to a related person who is a Western Hemisphere Trade Corpo-

48. INT. REV. CODE OF 1954, § 993(c)(1)(C); Proposed Treas. Reg. § 1.993-3(e)(1).

49. INT. REV. CODE OF 1954, § 993(c)(1); Proposed Treas. Reg. § 1.993-3(e)(4).

50. INT. REV. CODE OF 1954, § 993(a)(2)(A). While technically not part of the definition of export property, the "ultimate use" test has been so treated in the proposed regulations. Proposed Treas. Reg. § 1.993-3(d)(4).

51. INT. REV. CODE OF 1954, § 993(c)(2)(A); Proposed Treas. Reg. § 1.993-3(f)(2).

52. INT. REV. CODE OF 1954, § 993(a)(2). See Proposed Treas. Reg. § 1.993-3(a)(2), (d)(1).

ration will not qualify as export property. The statutory authority for this prohibition which appears in the proposed regulations is somewhat unclear, particularly in view of the fact that the Western Hemisphere Trade Corporation provisions of the Code were amended as part of the DISC legislation without providing for such a prohibition.⁵³ Nevertheless, this rule is a reasonable means of preventing a possible double tax benefit on the same transaction which would otherwise be available where a DISC or its principal sells or leases property to a WHTC for resale or sublease outside the United States.

Related and Subsidiary Services

Qualified export receipts also include receipts for services which are related and subsidiary to any qualified sale or lease of export property.⁵⁴ Services will be considered related to a qualified sale or lease if they are of the type customarily and usually furnished with the particular sale or lease. Examples of related services include warranty services, maintenance, repair, installation and transportation. Financing services are, however, excluded.⁵⁵

Services will be considered subsidiary to a qualified sale or lease if it is reasonably expected, at the time of the sale or lease, that gross receipts from all related services will constitute no more than 50 percent of the sum of the receipts from the sale or lease, plus the receipts from the related services.⁵⁶

Engineering and Architectural Services

Qualified export receipts also includes receipts for engineering or architectural services for construction projects located (or proposed for location) outside the United States.⁵⁷ The key terms here are "engineering services," "architectural services," and "con-

53. INT. REV. CODE OF 1954, § 922; Proposed Treas. Reg. § 1.993-3(a) (4). The Treasury Handbook on the DISC provisions, issued January 24, 1972, did not include this prohibition on sales to a WHTC. Thus, there is some question whether the proposed regulations which were issued on October 4, 1972, should be applied retroactively. See U.S. TREASURY DEPARTMENT, DISC, A HANDBOOK FOR EXPORTERS (1972) at 10.

54. INT. REV. CODE OF 1954, § 993(a) (1) (C).

55. Proposed Treas. Reg. § 1.993-1(d) (3).

56. Proposed Treas. Reg. § 1.993-1(d) (4).

57. INT. REV. CODE OF 1954, § 993(a) (1) (G).

struction project" which are all defined in the proposed regulations.⁵⁸ The services, which include feasibility studies, may be performed within or without the United States. Despite the inclusion of this category of income in the definition of qualified export receipts, engineering and architectural firms are likely to have difficulty in taking advantage of the DISC provisions because of the limited means at their disposal for satisfying the 95 percent assets test.

Miscellaneous Receipts

Lesser forms of qualified export receipts include receipts from the disposition of qualified export assets (other than export property), dividends from a related foreign export corporation, interest on an obligation which is a qualified export asset, and receipts for managerial services performed for other, unrelated DISCs.⁵⁹

Excluded Receipts

Notwithstanding the fact that receipts from the sale or lease of export property or from other export-related transactions may otherwise fall within the definition of qualified export receipts, such receipts will not be so treated under the following circumstances:

(a) Receipts from the sale of export property accomplished by one of the subsidy programs designated by the Treasury in the DISC regulations will not be treated as qualified export receipts.⁶⁰ To date, six subsidy programs have been listed in the proposed regulations, primarily pertaining to the export sale of agricultural products.⁶¹ DISC treatment was withheld from the recent wheat sales to the Soviet Union under this provision.

(b) Receipts from the sale or lease of export property or from the furnishing of engineering or architectural services for use by the United States government will not be treated as qualified export receipts where such sale or lease or the furnishing of such services is required by law or regulations.⁶² For example, sales to the Department of Defense for resale abroad at military commissaries will not result in qualified export receipts. However, the proceeds of sales to U.S. military agencies for resale abroad

58. Proposed Treas. Reg. § 1.993-1(h) (5), (6), and (8).

59. INT. REV. CODE OF 1954, § 993(a) (1) (D), (E), (F), and (H).

60. INT. REV. CODE OF 1954, § 993(a) (2) (B).

61. Proposed Treas. Reg. § 1.993-1(j) (3).

62. INT. REV. CODE OF 1954, § 993(a) (2) (C).

through post exchanges will be qualified export receipts.⁶³ Moreover, sales to the U.S. government for resale to a foreign government or under a program which provides for international competitive bidding will not be disqualified.

Nonqualified Receipts

A DISC may earn up to 5 percent of its total gross receipts in the form of nonqualified export receipts. In the case of a buy-sell or commission DISC dealing in a large volume of export transactions, the amount of permitted nonqualified receipts will be substantial.⁶⁴ In effect, a DISC can serve as a tax shelter for 5 percent of its total gross receipts.⁶⁵ For example, a DISC may want to make a short-term loan of its excess funds to its parent, in which case the interest received from the parent would not be a qualified receipt but would qualify for DISC benefits if the sum of all the DISC's nonqualified receipts did not exceed 5 percent of its total gross receipts.

However, a DISC should leave some margin for error. If the amount of nonqualified gross receipts exceeds 5 percent of the DISC's total gross receipts, the DISC will be required to make a deficiency distribution of the taxable income attributable to its total nonqualified receipts,⁶⁶ or it will be disqualified with the consequences described later in this article. A deficiency distribution can be made within 8 ½ months after the close of the DISC's taxable year provided at least 70 percent of its gross receipts are

63. Proposed Treas. Reg. § 1.993-1(j)(4)(i); Rev. Rul. 73-71, 1973 *INT. REV. BULL.* No. 6 at 28.

64. For example, assume gross receipts from sales of export property are \$10,000,000 per annum. The DISC would be permitted to earn approximately \$526,000 of nonqualified receipts without disqualification. This would be the case whether the DISC acts as principal or agent. See note 34, *supra*.

65. Since 50 percent of the DISC's taxable income is deemed to have been distributed to the DISC's shareholders each year, this would be a limited tax shelter.

66. *INT. REV. CODE OF 1954*, § 992(c)(1)(A). For example, assume that the DISC has \$95,000 qualified export receipts, but \$7,000 nonqualified receipts. It will be required to make a deficiency distribution of the taxable income attributable to the \$7,000, not just the \$2,000 necessary to come within the 95 percent gross receipts test. Moreover, in determining such taxable income, the DISC is not permitted to deduct any indirect expenses. Proposed Treas. Reg. § 1.992-3(b)(2).

qualified export receipts. Otherwise, a deficiency distribution can only be made upon a showing of reasonable cause for failure to meet the 95 percent gross receipts test, and failure to make such distribution prior to the date on which made.⁶⁷ Examples of reasonable cause given in the proposed regulations include a section 482 adjustment, an unanticipated insurance recovery or reasonable uncertainty as to what constitutes a qualified export receipt.⁶⁸

A deficiency distribution must be designated as such by the DISC at the time of the distribution by notice to its shareholders. A deficiency distribution is taxable to the recipient as an ordinary dividend, except that a corporate shareholder of a DISC will not be entitled to an intercorporate dividends received deduction with respect to such distribution.⁶⁹

AMOUNT OF INCOME A DISC MAY EARN

The intercompany pricing rules of I.R.C. section 994(a) are the heart of the DISC provisions. Ordinarily, the taxable income of a corporation purchasing goods from or, acting on behalf of, a related corporation would be determined under the section 482 regulations. These regulations are extremely complex and may be difficult to apply to specific situations. Moreover, in the case of a commission DISC operating with a minimum of corporate substance, section 482 would severely limit the amount of income from the transaction which the DISC could earn.

Thus, in order to simplify the operation of the DISC provisions and to maximize the amount of income which can be allocated to a DISC, section 994(a) provides certain objective pricing guidelines which apply where a DISC acts in conjunction with a related person (known as the "related supplier").⁷⁰ Under these rules, the DISC is permitted to earn the greater of (1) 4 percent of the qualified export receipts from the transaction, plus 10 percent of the DISC's export promotion expenses ("4 percent method"), or (2) 50 percent of the combined taxable income of the DISC and its related supplier from the transaction, plus 10 percent of the DISC's export promotion expenses (50-50 method). If either the 4 percent method or the 50-50 method is used in determining the taxable income of a DISC, then section 482 will not be applied to the DISC unless it produces a more favorable result.⁷¹

67. INT. REV. CODE OF 1954, § 992(c) (2); Proposed Treas. Reg. § 1.992-3(c) (1).

68. Proposed Treas. Reg. § 1.992-3(c) (2).

69. INT. REV. CODE OF 1954, §§ 246(d), 996(a) (2).

70. H.R. REP., *supra* note 29, at 73; S. Rep., *supra* note 2 at 107.

71. Proposed Treas. Reg. § 1.994-1(a). However where the related sup-

Example of Pricing Rules

These pricing rules can best be understood by working through an example involving the sale of export property through a commission DISC. Assume P sells 100 units of export property for \$1,000 and designates its DISC to act as commission agent with respect to the sale. P's cost of goods sold attributable to the 100 units is \$620. Its direct selling expenses are \$130 and its other indirect expenses (such as administrative overhead) apportioned to the sale of export property are \$100.⁷² The DISC pays \$100 to independent contractors which qualify as export promotion expenses. The commission which the DISC can earn on the transaction is computed as follows:

(1) Combined taxable income:		
(a) P's sales price		\$1,000
(b) Less deductions:		
P's cost of goods sold	\$ 620	
P's direct selling expenses	130	
P's indirect expenses apportioned to sale of export property	100	
DISC's export promotion expenses	100	
Total deductions		950
(c) Combined taxable income		\$ 50
(2) DISC's profit under 50-50 method:		
(a) 50 percent of combined taxable income		\$ 25
(b) Plus: 10 percent of DISC's export promotion expenses		10
(c) DISC's profit		\$ 35
(3) DISC's profit under 4 percent method:		
(a) 4 percent of P's sales price		\$ 40
(b) Plus: 10 percent of DISC's export promotion expenses		10
(c) DISC's profit		\$ 50

Since the 4 percent method results in greater profit to the DISC (\$50) than does the 50-50 method (\$35), P may pay its DISC a com-

plier of a DISC purchases from or sells to a related person, the purchase price or the sales price, as the case may be, will be subject to section 482. Proposed Treas. Reg. § 1.994-1(e)(2).

72. The apportionment of indirect expenses to gross receipts in arriving at combined taxable income is governed by the rules set forth at Proposed Treas. Reg. § 1.861-8. See Proposed Treas. Reg. §§ 1.994-1(c)(6)(iii), 1.861-8(f)(1)(iii).

mission of \$50 on the transaction.⁷³ In fact, whenever the profit margin on the export sales is less than 8 percent, it will be more advantageous to use the 4 percent method than the 50-50 method in computing the DISC's taxable income. Here, the profit margin was only 5 percent (\$50 profit on \$1,000 sales), so the 4 percent method produces a better result.

Transactions to which I.R.C. Section 994(a) Applies

The pricing rules set forth in section 994(a) are not limited in their application to export sales transactions. They apply to leases of export property to a DISC for sublease, as well as the various services which produce qualified export receipts.⁷⁴ For example, if an architectural firm had a contract for work on the construction of a building to be located abroad, it could organize a DISC subsidiary and pay it a commission based on the pricing rules contained in section 994(a). In such case the architectural firm would be the "related supplier" and principal of the DISC.

Grouping of Transactions

In general, the determination of a DISC's taxable income under the section 994(a) pricing rules is to be made on a transaction-by-transaction basis. However, at the annual election of the taxpayer, the pricing rules may be applied on the basis of groups consisting of products or product lines.⁷⁵ This is often the more practical method. The proposed regulations indicate that the Service will accept any grouping of product lines provided "it conforms to any recognized industry or trade usage." Thus, if a firm is manufacturing farm tractors and trucks for export, it could apply the pricing rules to individual sales of tractors or trucks, or to separate product lines consisting of all tractors and all trucks sold during that year. The taxpayer could also apply the pricing rules to all tractors sold during the year as a separate product line and then to truck sales on a transaction-by-transaction basis.

73. If P wanted to reimburse its DISC for its export promotion expenses, it could pay the DISC a commission of \$150 (\$50 profit plus \$100 to cover the DISC's expenses). Proposed Treas. Reg. § 1.994-1(d)(2)(ii). 37 Fed. Reg. 28066. If the DISC were a buy-sell DISC, the transfer price between P and the DISC would be adjusted so that the DISC would earn a \$50 profit on the resale. Thus, the DISC would pay \$850 to P for the 100 units and resell them for \$1,000.

74. Proposed Treas. Reg. § 1.994-1(b). However, the intercompany pricing rules would not apply if a DISC purchased export property from its related supplier and leased such property to a third party.

75. Proposed Treas. Reg. § 1.994-1(c)(7).

The grouping of transactions and the selection of product lines is of critical importance, because the taxpayer can use a different pricing method for each transaction or product line. For example, if it were advantageous to do so, the taxpayer could use the 4 percent method with respect to tractor sales and the 50-50 method with respect to truck sales. Whether it would be desirable to use different pricing methods for different product lines would depend on the respective profit margins for each product line, after computing cost of goods sold and selling expenses, and apportioning other indirect expenses. Moreover, in cases where the 4 percent method is used for all transactions, there may still be advantages in grouping these transactions into different product lines within the limits of recognized industry or trade usage.⁷⁶ Thus, the rules relating to grouping of transactions provide a great deal of flexibility in applying the pricing rules to obtain the best overall result, although the determination of the most advantageous product line groupings may involve extensive and complex computations.

No-Loss Rule

An important limitation on the application of the pricing rules is that neither the 4 percent method nor the 50-50 method can be applied to cause a loss to the related supplier of the DISC, with respect to the transaction or product line.⁷⁷ For this purpose a loss will result if the amount of income allocated to the DISC exceeds the combined taxable income of the DISC and its related supplier. This limitation, referred to in the proposed regulations as the "no-loss" rule, is applicable primarily to the 4 percent method, and only in rare cases would affect the 50-50 method.⁷⁸ For ex-

76. For example, assume that the profit on \$1,000 receipts from the sale of tractors is \$50, while profit on \$1,000 receipts from the sale of trucks is only \$20. If the 4 percent method is applied separately to each product line, the total income which could be allocated to the DISC is \$60 (\$40 on the tractor sales, but only \$20 on the truck sales because of the operation of the "no-loss" rule described below). However, if the 4 percent method is applied to all tractor and truck sales as one product line (e.g., vehicles), \$70 could be allocated to the DISC under the "no-loss" rule.

77. Proposed Treas. Reg. § 1.994-1(e)(1).

78. Since, under the 50-50 method, the amount of income allocated to a DISC is based primarily on 50 percent of combined taxable income, the DISC would have to incur an excessive amount of export promotion expenses before its income would exceed combined taxable income. A special rule is applicable in applying the "no-loss" rule to the 4 percent

ample, in the illustration provided above, if P's direct selling expenses were \$150 instead of \$130, the combined taxable income would be \$30, and, since the taxable income of the DISC under the 4 percent method (\$50) would exceed combined taxable income (\$30), the related supplier, P, would have a \$20 loss on the transaction. Thus, the maximum amount of income which could be allocated to the DISC under section 994(a) would be \$30, even though the 4 percent method results in a higher amount of DISC taxable income.⁷⁹

Procedures for Payment of Commission or Transfer Price

It is not necessary for the related supplier to make current payments of commissions to its DISC. In fact, the initial payment of the commission is not due until 60 days following the close of the DISC's taxable year in which the transaction occurs.⁸⁰ On or before such date, a commission DISC must be paid a reasonable estimate of the amount owing to it under the intercompany pricing rules. For this purpose, 50 percent of the DISC's taxable income will be considered a reasonable estimate.⁸¹

A commission DISC and its related supplier have until the date for filing the DISC's tax return (8 ½ months after the close of the DISC's taxable year) within which to make a final adjustment of the amount of commissions owing to the DISC.⁸² For example,

method whereby the taxable income of the related supplier from all sales, domestic and foreign, may be taken into account. Proposed Treas. Reg. § 1.994-1(e) (ii).

79. If there is no combined taxable income on an export transaction because, for example, the transaction results in a loss, the DISC may recover its costs, if any, without violating the no-loss rule. Proposed Treas. Reg. § 1.994-1(e) (1) (i).

80. Proposed Treas. Reg. § 1.994-1(e) (3).

81. If the initial payment does not represent a reasonable estimate of the commissions owing to the DISC, an indebtedness will be deemed to arise as of the 60th day following the close of the DISC's taxable year for the amount of the difference. An arm's length rate of interest must be paid to the DISC with respect to such indebtedness and the obligation will not be treated as a "qualified export asset" in the hands of the DISC. Proposed Treas. Reg. §§ 1.994-1(e) (3), 1.993-2(d) (3). However, this last sanction is not likely to be serious since the 95 percent assets test is applied on the last date of the DISC's year and the related supplier can pay off its indebtedness before the end of such year. A more serious question is the consequences of not making *any* payment within the 60 day period. It would appear that an obligation is deemed to arise on the last day of the DISC's prior year which would not constitute a qualified export asset. Proposed Treas. Reg. § 1.993-2(d) (2). Finally, there is some question whether the payment during the 60 day period can take the form of a note from the related supplier for a reasonable estimate of the commissions to be subsequently determined.

82. Proposed Treas. Reg. § 1.994-1(e) (4).

if the amount paid to the DISC as a reasonable estimate within the 60-day period referred to above is too small, then the related supplier can pay the balance due before the date for filing the DISC's tax return. Alternatively, the DISC can establish an account receivable for the balance of the commissions owed to it. This receivable must bear an arm's-length rate of interest and must be paid within 90 days.⁸³

These rules, which were intended to give the taxpayer a reasonable period of time after the close of the DISC's taxable year to make the computations required to apply the intercompany pricing rules, can be illustrated by using the figures of the example set forth above:

Assume the DISC is on a calendar year and that the taxable year in which the sale occurred is 1972. On or before March 1, 1973, P should pay to its DISC an amount which it reasonably estimates to be the commission owing to the DISC with respect to the sale of the 100 units. Thus, on March 1, 1973, P pays its DISC \$25. Before September 15, 1973, the date for filing the DISC's return, P must determine the total commission owed to its DISC with respect to the sale. This amount will be \$50 and P must either pay the DISC an additional \$25 before September 15, 1973, or the DISC must establish an account receivable from P on its books for such amount. If the latter course is followed, interest must be paid by P at a rate of 4 percent per annum and the receivable must be closed no later than December 14, 1973.⁸⁴

The same procedures are applicable to a buy-sell DISC, except that it is the DISC's obligation to make an initial payment of the transfer price and to make a final adjustment before filing its return. Thus, if the DISC's related supplier has need for the funds, the DISC will want to make prompt payment, and not wait the maximum time allowed under the proposed regulations.

83. Proposed Treas. Reg. § 1.994-1(e)(5). Payment of the balance due or the outstanding receivable can take the form of a note from the related supplier. The note would not appear to constitute a qualified export asset in the hands of the DISC and thus should be paid off before the end of the DISC's year. Proposed Treas. Reg. § 1.993-2(d)(3).

84. Because of the importance of the timing of these procedures, the taxpayer would be well advised to outline them in the franchise agreement with the DISC described earlier.

Export Promotion Expenses

Whether the taxpayer uses the 4 percent method or the 50-50 method, the amount of income which can be allocated to a DISC will be increased by 10 percent of the export promotion expenses incurred by the DISC. Export promotion expenses are those expenses incurred to advance the distribution or sale of export property.⁸⁵ Such expenses would include costs of installation services, warranty costs, general and administrative expenses attributable to billing customers, expenses for market studies, advertising, salaries and wages of sales, clerical and other personnel, rentals on property, sales commissions, warehousing, freight costs, packaging costs, and 50 percent of the cost of shipping export property aboard U.S. registered ships or aircraft where law or regulation does not require shipment aboard such ships or aircraft.⁸⁶ Certain expenses are ineligible to be treated as export promotion expenses such as interest expenses, bad debt expenses, freight insurance, foreign income taxes, and shipping costs not covered by the special 50 percent rule mentioned above.⁸⁷

More significantly, export promotion expenses must be incurred by the DISC.⁸⁸ Expenses incurred by the DISC's related supplier and billed to the DISC will not qualify as export promotion expenses. Thus, a commission DISC which is operating with a minimum of corporate substance will have few, if any, export promotion expenses except to the extent it pays independent contractors for such services as market studies, advertising or sales commissions to unrelated distributors.⁸⁹ On the other hand, the Service has recognized in Revenue Ruling 73-96⁹⁰ that expenses which are incurred by the DISC's employees, but paid by the DISC's parent and then billed to the DISC through the parent's centralized computer system, can qualify as export promotion expenses.

85. INT. REV. CODE OF 1954, § 994 (c).

86. Proposed Treas. Reg. § 1.944-1(f) (1), (2), (4), (5), (6). The list of qualifying expenses specified in the proposed regulations is not exhaustive. See Rev. Rul. 72-582, 1972 INT. REV. BULL. No. 49 at 11, to the effect that contributions by a DISC to a nonprofit research organization engaged in work on documents used in international trade are export promotion expenses.

87. Proposed Treas. Reg. § 1.994-1(f) (3).

88. Proposed Treas. Reg. § 1.994-1(f) (7) (i).

89. Proposed Treas. Reg. § 1.994-1(f) (7) (ii). To be treated as an export promotion expense, the expense must result from a payment to the DISC's employees or must be incurred by the DISC's employees. Proposed Treas. Reg. § 1.994-1(f) (7) (i).

90. 1973 INT. REV. BULL. No. 8 at 10.

*Marginal Costing Rules*⁹¹

Marginal costing is a system of allocating costs between export transactions and other gross receipts of the taxpayer for purposes of computing combined taxable income under the 50-50 pricing method.⁹² Under the proposed marginal costing regulations, only the following categories of costs need be deducted from gross receipts in determining the combined taxable income of a DISC and its related supplier:⁹³

- (a) direct materials;
- (b) direct labor; and
- (c) export promotion expenses claimed by the DISC.

Indirect costs associated with producing or selling the item or product line are not deducted from gross receipts in computing combined taxable income as they would be under the "full costing" method. Thus, by restricting the costs which are deducted under the 50-50 method and thereby increasing the amount of income which can be allocated to a DISC, the marginal costing rules can, within the limits described below, result in significant benefits to taxpayers using the intercompany pricing rules. For example, in the illustration provided above, if P's indirect costs (\$100) and selling expenses (\$130) are excluded under marginal costing because they are not direct costs, the combined taxable income on the sale of the 100 units would be \$280 (\$1,000-\$720). However, the extent to which this amount can be allocated to the DISC under

91. For a more complete discussion of the marginal costing rules than the one which follows, see Rendell & Norman, *DISC—Marginal Costing and Other Recent Developments*, TAX MANAGEMENT MEMORANDUM 73-06 (March 19, 1973); Kauder, *Marginal costing for DISCs: An Explanation and analysis of Treasury's Proposed Regulations*, 38 J. OF TAXATION 304 (1973).

92. INT. REV. CODE OF 1954, § 994(b)(2). The legislative history makes it clear that this statutory language was intended to authorize the Treasury to promulgate marginal costing regulations. S. Rep. No. 437, *supra* note 2, at 108. See Proposal Treas. Reg. § 1.994-2. The marginal costing rules are not applicable in determining combined taxable income under the "no-loss" rule as it applies to the 4 percent method. Proposed Treas. Reg. § 1.994-2(a).

93. Proposed Treas. Reg. § 1.994-2(b)(2). The marginal costing regulations do not contain a definition of "direct materials" or "direct labor." Instead, the proposed regulations refer to section 471 relating to inventories and the regulations thereunder. Proposed regulations were issued under section 471 on February 12, 1973 and adopted September 14, 1973, by T.D. 7285. See especially, Treas. Reg. § 1.471-11.

the 50-50 method depends on the operation of the "overall profit percentage limitation."

Overall Profit Percentage Limitation

Under the proposed regulations, the maximum amount of combined taxable income computed under marginal costing which can be allocated to a DISC under the 50-50 method is an amount equal to the gross receipts from export sales of the item or product line multiplied by the overall profit percentage.⁹⁴ The overall profit percentage is computed by dividing the taxable income from all sales, domestic and foreign, of the product line computed under full costing by the total gross receipts from all sales, domestic and foreign, of that product line. For example, assume that in addition to selling 100 units for export, P sells 300 additional units of the same product line for domestic consumption. The gross receipts from the 300 units is \$3,000 and the profit on these sales, computed under full costing is \$310. The overall profit percentage limitation would be computed as follows:

(1) Gross receipts from export sales:		\$1,000
(2) Overall profit percentage:		
(a) Taxable income from all domestic and foreign sales:	360	
(b) Gross receipts from all domestic and foreign sales:	4,000	
(c) (a) divided by (b)		<u>x.09</u>
(3) Overall profit percentage limitation		
(1) multiplied by (2) (c)		\$ 90

Since the overall profit percentage limitation (\$90) is less than combined taxable income under marginal costing (\$280), the maximum amount of combined taxable income is \$90. Thus, the profit which the DISC can earn on the transaction under the 50-50 method is \$55 (\$45 plus \$10 export promotion expenses).⁹⁵ Thus, while the overall profit percentage limitation has significantly reduced the benefits of marginal costing in this example, marginal costing is still more advantageous than either the 50-50 method or 4 percent method computed under full costing.

The key to applying the overall profit percentage limitation is the determination of product lines. The taxpayer is not bound to use the same product line grouping under the marginal costing

94. Proposed Treas. Reg. § 1.994-2(b) (3), (c) (2).

95. The "no-loss" rule here would not limit this amount since the proposed marginal costing regulations provide that the "no-loss" rule is applied on the basis of combined taxable income computed per marginal costing. Proposed Treas. Reg. § 1.994-2(d).

rules as it uses for purposes of applying the intercompany pricing rules, provided the grouping chosen for determining the overall profit percentage is at least as broad as the grouping used under section 994(a).⁹⁶ Thus, if P in the example given above can determine the overall profit percentage limitation on the basis of some other product line which results in a percentage in excess of 9 percent, it can obtain further benefits from the marginal costing rules.

Further Limitations on Marginal Costing

The legislative history of section 994(a) (2) indicates that marginal costing should only be used in those cases where a DISC is seeking to establish or maintain a market for export property.⁹⁷ However, rather than attempt to define this concept, the proposed marginal costing regulations merely provide that a DISC will be considered to have satisfied this requirement if the combined taxable income under marginal costing is greater than combined taxable income under full costing.⁹⁸ Since this will always be the case, the Treasury has, in effect, eliminated the "seeking to establish or maintain a market" requirement.⁹⁹

Nevertheless, other limitations exist. Marginal costing can only be used with respect to sales to a related foreign corporation where the resale of the export property by the foreign corporation would not produce Subpart F income under section 954(d).¹⁰⁰ This restriction would appear to apply, even if the related foreign corporation were included in a minimum distribution election under section 963. This would not preclude use of marginal costing on sales of export property to a related foreign manufacturing corporation for use in a foreign manufacturing process since the subsequent sale by the foreign corporation would not ordinarily produce Subpart F income. Finally, it would appear that the marginal costing rules would not apply to purchases and sales of export

96. Proposed Treas. Reg. § 1.994-2(c) (3).

97. S. REP. No. 92-437, *supra* note 2, at 108.

98. Proposed Treas. Reg. § 1.994-2(c) (1).

99. See Treas. Reg. § 1.482-2(e) (2) (iv).

100. Proposed Treas. Reg. § 1.994-2(a). Exceptions are provided for Subpart F income excluded under the "70-30" rule or under section 954 (b) (4).

property by a DISC or its related supplier; the related supplier may have to be a manufacturer of export property.¹⁰¹

Evaluation of Marginal Costing Regulations

In general, the marginal costing rules mean that the combined taxable income of a DISC and its related supplier computed under full costing can be increased to the lesser of (1) the overall profit percentage limitation, or (2) combined taxable income computed under marginal costing. Thus, the computation of the overall profit percentage will determine the usefulness of marginal costing, and, in this regard the selection of product lines on which to base the percentage will be particularly important. If the profit percentages of the taxpayer on domestic sales are generally higher than the profit percentages on export sales, the taxpayer should derive some benefit from marginal costing. However, if the overall profit percentage does not exceed 8 percent, the taxpayer will not derive any benefit from marginal costing regardless of the relative profitability of domestic and export sales. In such case, either the 4 percent method or the 50-50 method computed under full costing will result in greater allocation of taxable income to the DISC.

HOW A DISC MAY INVEST ITS EARNINGS

I.R.C. section 992(a)(1)(B) provides that to qualify as a DISC for a taxable year, 95 percent of the adjusted basis of a corporation's assets at the close of the taxable year must consist of qualified export assets. By restricting the term "qualified export assets" to assets used in or arising from an exporting business, the 95 percent assets test was intended to limit the DISC benefits to firms which are involved primarily in exporting operations and to encourage expansion of export facilities. It is important to note that the test is applied to the adjusted basis of the DISC's assets, and fair market value is of no relevance (except, as noted below, in computing the amount of a deficiency distribution).

The 95 percent asset tests need be satisfied only at the end of the DISC's taxable year. Thus, a DISC may hold a non-qualified asset during the year, and it will not be taken into account as long as the DISC disposes of such asset before the last day of its taxable year. For example, a DISC could make short-term loans to its parent or a related company (even though such loans do not qualify as producer's loans) without the resulting obligations count-

101. See Proposed Treas. Reg. § 1.994-2(b)(1).

ing for purposes of the 95 percent assets test, provided the loans were paid off before the end of the DISC's year. However, the proposed regulations indicate that a DISC may not borrow funds to acquire a qualified asset which is held for 60 days or less in order to satisfy the 95 percent assets test, unless the acquisition of the asset was made for bona fide purposes (such as an acquisition made in the usual course of the DISC's trade or business).¹⁰²

In defining qualified export assets, the Treasury introduced a new concept into the tax law, that of a producer's loan. The producer's loan mechanism, which is discussed in detail below, was intended to enable the DISC to meet the 95 percent assets test by loaning its tax deferred earnings to a domestic manufacturer, whether or not related to the DISC, which is producing goods for export. However, because of the numerous substantive restrictions on producer's loans, and the complexity of these provisions, producer's loans have not as yet been extensively used as a means of satisfying the 95 percent assets test. Instead, the most popular use of tax deferred earnings has been, in the case of commission DISCs, to purchase export trade receivables, and, in the case of buy-sell DISCs, to purchase export inventory.

Commission DISCs: Trade Receivables

In most cases, a commission DISC will look to its related supplier's receivables arising from export sales as a means of satisfying the 95 percent assets test. Since a commission DISC will not carry any export inventory and will need only a minimal amount of capital assets in its business, the most readily available use of the DISC's tax deferred earnings is to purchase these receivables from its related supplier.

The proposed regulations¹⁰³ specify that trade receivables ac-

102. Proposed Treas. Reg. § 1.992-1(c)(2). Assets acquired under these circumstances (without showing a bona fide purpose) are disregarded in applying the 95 percent assets test.

103. Under section 993(b)(3), qualified export assets include accounts receivable and evidences of indebtedness which arise by reason of a transaction producing qualified export receipts. Proposed Treas. Reg. § 1.993-2(d)(1) makes it clear that a commission DISC can acquire its principal's receivables. It is not clear whether the DISC can acquire these receivables at a discount which would have the effect of maximizing deferral of tax on the transaction.

quired by a DISC will be treated as qualified export assets provided:

- (1) the receivable is due the DISC or its principal, and
- (2) the receivable arose in a transaction resulting in qualified export receipts for the DISC.

Thus, where a DISC acts as a commission agent it can purchase (with or without recourse) trade receivables owing to its principal as a result of a qualified export transaction with respect to which the DISC receives a commission. If the commission DISC will not receive a commission on the underlying transaction, it may not purchase the receivables resulting from such transaction. For example, if a manufacturer uses multiple DISCs, one DISC cannot purchase the receivables arising from an export transaction with respect to which the other DISC receives a commission. Moreover, a corporation organized exclusively to finance export sales within an affiliated group of corporations will not qualify as a DISC, because it does not participate in the underlying transaction which gave rise to the receivable.

Depending on the volume of the related supplier's export sales made on credit and the rapidity with which the trade receivables turn over in the hands of the related supplier, the DISC can satisfy the 95 percent assets test by financing these export credit sales for a number of years. For example, assume that the DISC's related supplier has an export credit sales volume of \$10,000,000 per year, with an average term of 90 days for its receivables, and that the DISC is paid a commission of \$500,000 for these sales under the 50-50 pricing method. At the end of the DISC's first year, it will not have a problem meeting the 95 percent assets test because its only asset will be a receivable owing from its related supplier representing the commission for first year's sales, which will be treated as a qualified export asset.¹⁰⁴ During the course of the DISC's second year it will receive the \$500,000 commission from its related supplier for sales during the first year, and will distribute \$250,000, the amount treated as a deemed distribution with respect to the DISC's first year. Thus, it will have \$250,000 which must be invested in qualified export assets. Assuming that the related supplier's sales are evenly distributed throughout the year, its outstanding receivables at the close of the DISC's second year will be \$2,500,000, and the DISC could acquire \$250,000 worth of these receivables (assuming for purposes of simplification that no discount

104. Proposed Treas. Reg. § 1.993-2(d) (2), (3). Under Proposed Treas. Reg. § 1.994-1(e) (3), (4), (5), payment of commissions owing to a DISC need not be made until after the close of the DISC's taxable year. See text at notes 80-84, *supra*.

is charged by the DISC) with its tax deferred earnings.¹⁰⁵ This process could continue for 9 more years until the total accumulated tax deferred earnings held by the DISC equal the related supplier's receivables outstanding at the end of the DISC's year.

Buy-Sell DISCs: Purchases of Inventory

Receivables owing to a buy-sell DISC from its foreign customers will be treated as qualified export assets. However, a buy-sell DISC will also have assets consisting of accumulated tax-deferred earnings attributable to the mark-up on export sales which it must invest in a manner to satisfy the 95 percent assets test. These earnings can be used to acquire additional inventory from the DISC's related supplier, or to pay for inventory previously purchased from the related supplier but not paid for at the end of the DISC's year (i.e., orders already shipped to foreign customers but not paid for by the end of the year).¹⁰⁶ To illustrate: in the example given directly above, as of the end of its first year, the DISC would have \$2,500,000 receivables due from foreign customers for sales made in the last three months of the year which would be qualified export assets. In addition, it would have cash of \$125,000, representing the difference between the income actually received by the DISC during its first year (\$375,000 mark-up based on estimates under the intercompany pricing rules) and the \$250,000 deemed distribution actually paid out by the DISC during the year. Assuming the DISC pays for inventory purchased from its related supplier when it collects the sales price from its foreign customers, at the end of the year it would owe \$2,375,000 to its related supplier.¹⁰⁷ The DISC could utilize the \$125,000 to prepay

105. It is understood that the Internal Revenue Service has issued a private ruling that the DISC can purchase an undivided interest in its related supplier's export trade receivables, and that it is not necessary to specifically identify those receivables which have been purchased by the DISC (as long as they result from a transaction giving rise to qualified export receipts). Thus, the related supplier would collect the receivable as agent for the DISC and remit the amount collected to the DISC.

106. Under section 993(b)(1), qualified export assets include export property. Prepayment of inventory purchases would have the effect of eliminating the tax deferred earnings from the DISC's balance sheet, i.e., cash representing such earnings would be used to reduce a payable of the DISC.

107. The transfer price for the inventory is completed under section 994(a) by subtracting the DISC's taxable income and expenses from the

the amount it owes its related supplier for inventory purchases. In effect, the buy-sell DISC can satisfy the 95 percent assets test by accelerating the payments for inventory purchases. To the extent the DISC's accumulated tax deferred earnings exceed the amount owing to the related supplier at the end of the year, the DISC could purchase additional export property as inventory prior to receipt of orders from the foreign customers.

Producer's Loans

A producer's loan is a loan made by a DISC to a borrower engaged in the United States in the manufacture of export property. The borrower need not be related to the DISC, but in most cases it undoubtedly will be. The obligation of the borrower to repay the producer's loan must be evidenced by a note or other evidence of indebtedness with a stated maturity of 5 years or less.¹⁰⁸ At the time the loan is made, it must be designated as a producer's loan by a legend on the obligation stating "This Obligation Is Designated A Producer's Loan Within the Meaning of Section 993(d) of the Internal Revenue Code."¹⁰⁹ Thus a DISC cannot treat a loan to a related person as a producer's loan after the fact.

A producer's loan which meets these requirements and the limitations set forth below will be treated as a qualified export asset. In addition, the proposed regulations clearly state that a producer's loan will not be treated as a dividend from the DISC to a related borrower.¹¹⁰

A producer's loan is subject to three limitations described below. These limitations are applied at the time of making the loan. Subsequent events will not result in disqualification of the loan and will not qualify an otherwise defective loan.¹¹¹ It would appear that a producer's loan which fails to meet any one of these limitations will be disqualified only to the extent of the excess of the amount of the loan (when added to the unpaid balance of all other producer's loans) over the applicable limitation, and the entire amount of the loan will not be disqualified.

sales price paid by the foreign customer. Here, it has been assumed for purposes of simplification that the DISC has no expenses (\$2,500,000 — \$125,000 = \$2,375,000).

108. Producer's loans may be renewed or extended beyond the 5 years, but they must qualify as producer's loans again at such time. Proposed Treas. Reg. § 1.993-4(a)(2)(v), (4).

109. Proposed Treas. Reg. § 1.993-4(a)(1)(iv).

110. Proposed Treas. Reg. § 1.993-4(a)(2)(i).

111. Proposed Treas. Reg. § 1.993-4(a)(2)(vi).

Accumulated DISC Income

A loan by a DISC will only be treated as a producer's loan if it is made out of accumulated DISC income.¹¹² A loan is made out of accumulated DISC income only if the amount of the loan, when added to the unpaid balance of all other producer's loans made by the DISC, at the time of such loan, does not exceed accumulated DISC income at the beginning of the month in which the loan is made. As indicated below, accumulated DISC income is the equivalent of tax deferred income (i.e., DISC earnings less deemed distributions).

Borrower's Export-Related Assets

It is not necessary to trace the proceeds of a producer's loan to an investment by the borrower in any specific export related asset. However, the DISC provisions contain a limitation designed to insure that producer's loans do not exceed the amount of the borrower's assets considered as being related to its export sales.¹¹³ Under this limitation, which is expressed in terms of a formula, a producer's loan, when added to the unpaid balance of all other producer's loans to the borrower outstanding at the time such loan is made, may not exceed the following amount:

1. *The sum of:*

- (a) the borrower's adjusted basis at the beginning of its year in plant, machinery and equipment and supporting facilities located in the United States;
- (b) the amount of the borrower's property held primarily for sale or lease at the beginning of the year; *and*
- (c) the amount of the borrower's research and development expenditures since 1971.

2. *Multiplied by the fraction consisting of:*

The borrower's receipts during the three preceding years (but not including any year before 1972) from the sale or lease of export property; *divided by*

The borrower's total gross receipts during such three year period from property held primarily for sale or lease.

112. INT. REV. CODE OF 1954, § 993(d)(1)(A); Proposed Treas. Reg. § 1.993-4(a)(3).

113. INT. REV. CODE OF 1954, § 993(d)(2); Proposed Treas. Reg. § 1.993-4(b).

This formula is applied to each borrower on an individual basis, or, at the election of the borrower, it can be applied on the basis of a controlled group of corporations of which the borrower is a member.¹¹⁴ If such a group election is made, all investment and sales figures are taken into account by aggregating the amounts of each member of the group, excluding foreign corporations. Because the formula is applied to a three-year base period which may not include any taxable year of the borrower commencing prior to 1972, a producer's loan could not be made by a DISC until the close of the borrower's first taxable year commencing after December 31, 1971.¹¹⁵

Increased Investment

Finally, a loan by a DISC will only be treated as a producer's loan to the extent that the amount of the loan, when added to the unpaid balance of all other producer's loans made to the borrower during the taxable year, does not exceed the amount of the borrower's increase for the year in investment in export-related assets.¹¹⁶ The export-related assets are those referred to in 1(a), (b) and (c) above. However, the increased investment is measured in terms of increases in adjusted basis of assets. Therefore, it would appear that the borrower would have to offset its depreciation deductions for this purpose. As in the case of the formula for measuring export-related assets, a group election can be made by the borrower.

Evaluation of Producer's Loans

These limitations not only inhibit the extent to which a DISC can make producer's loans to satisfy the 95 percent assets test, but they are extremely cumbersome to apply, particularly for a small or medium sized firm lacking a substantial tax and accounting staff. These difficulties, coupled with the "fugitive capital rule" discussed briefly below, will greatly reduce the effectiveness of the producer's loan mechanism. In fact, a DISC would be well advised not to make any producer's loans unless it was no longer possible to acquire its related supplier's receivables or to purchase additional export inventory.

114. Proposed Treas. Reg. § 1.993-4(a)(2)(vii).

115. Proposed Treas. Reg. § 1.993-4(b)(3)(iii). This rule may create difficulties for borrowers on a fiscal year. For example, a borrower on a fiscal year ending October 31 could not receive a producer's loan until November 1, 1973.

116. INT. REV. CODE OF 1954, § 993(d)(3), Proposed Treas. Reg. § 1.993-4(c).

Miscellaneous Assets

Lesser forms of qualified export assets include assets used in a DISC's exporting business, temporary investments such as bank deposits to the extent reasonably necessary to meet the DISC's working capital requirements, stock or securities in a related foreign export corporation, obligations issued or guaranteed by the Export-Import Bank or the Foreign Credit Insurance Association, and obligations issued by a domestic corporation as part of a financing agreement with the Export-Import Bank.¹¹⁷ In addition, temporary investments in excess of the DISC's working capital requirements will be treated as qualified export assets provided they are invested in other qualified export assets within six months after the close of the DISC's year.¹¹⁸

Nonqualified Assets

If the adjusted basis of a DISC's nonqualified export assets exceeds 5% of the adjusted basis of its total assets, it can avoid disqualification by making a deficiency distribution in the same manner as described above with respect to nonqualified receipts. However, the amount of the deficiency distribution required to satisfy the 95% assets test is an amount equal to the fair market value of the nonqualified assets as of the last day of the DISC's year.¹¹⁹ Thus, even though the 95% assets test is computed according to adjusted basis of the DISC's assets, the amount of the deficiency distribution is determined on the basis of fair market value.

DISTRIBUTIONS OF A DISC¹²⁰

A DISC itself is not subject to income tax,¹²¹ even if the corporation's DISC election is terminated through revocation or disquali-

117. INT. REV. CODE OF 1954, § 993(b). A special limitation applies to Eximbank financing agreements acquired after November 3, 1972. Proposed Treas. Reg. § 1.993-2(h) (2), (i) (2). For the application of this special limitation, see TECH. INFO. REL. 1247 (July 25, 1973).

118. Proposed Treas. Reg. § 1.993-2(j) (2).

119. INT. REV. CODE OF 1954, § 992(c) (1) (B); Proposed Treas. Reg. § 1.992-3(b) (3).

120. See Bischel, *Proposed DISC Regs: Planning for deemed and actual distributions in qualified years*, 38 J. TAXATION 178 (1973).

121. INT. REV. CODE OF 1954, § 991; The DISC is, however, subject to the

fication. However, the DISC's shareholders are subject to tax on certain deemed distributions from a DISC as well as on actual distributions.

Deemed Distributions

The most important deemed distributions are 50 percent of the DISC's taxable income for the year and the amount of foreign investment attributable to producer's loans made by the DISC for the year.¹²² Both of these forms of deemed distributions were added to the DISC provisions by the Senate Finance Committee as a means of limiting the extent of tax deferral available to a DISC and its shareholders, and preventing the use of producer's loans to finance investments in foreign plant and equipment by the DISC's parent or affiliated company.¹²³

Since 50 percent of the DISC's taxable income is treated as a deemed distribution, it is necessary for the DISC to make accounting elections and to compute its taxable income even though it is not subject to tax.¹²⁴ An annual return must be filed by a DISC on Form 1120-DISC reflecting its taxable income.¹²⁵ The rules relating to the determination of the amount of foreign investment attributable to producer's loans (the so-called "fugitive capital rule") are extremely complex and, due to limitations of space, will not be discussed here.¹²⁶ It may be noted, however, that if the controlled group of corporations of which the DISC is a member has significant foreign operations, the fugitive capital rule could greatly inhibit the extent to which the producer's loans mechanism can effectively be used by the DISC. If the group's investment in foreign plant and equipment is financed out of depreciation funds, one-half the earnings and profits of the foreign members of the group and local sources of debt and equity, the adverse affect of the fugitive capital rule can be minimized or even eliminated. However, even where such local sources of financing are available, the complexity of the computations which must be made under the fugitive capital rule will act as a deterrent to the making

excise tax on transfers abroad of foreign stock or securities and the interest equalization tax. Proposed Treas. Reg. § 1.991-1(a).

122. INT. REV. CODE OF 1954, § 995(b). Other types of deemed distributions, not discussed herein, are interest from producer's loans and gain recognized by a DISC on the sale or exchange of property transferred to a DISC in a transaction in which gain was not recognized.

123. S. REP. NO. 437, *supra* note 2, at 91.

124. Proposed Treas. Reg. §§ 1.991-1(b); 1.996-8.

125. INT. REV. CODE OF 1954, §§ 6011(e)(2); 6072(b).

126. INT. REV. CODE OF 1954, § 995(d); *see generally* Proposed Treas. Reg. § 1.995-5.

of producer's loans. Of course, if the DISC does not make any producer's loans or if the producer's loans are made to an unrelated person, additions to the group's foreign plant will not affect the ability of the DISC to continue to defer tax on the 50 percent of its taxable income not deemed to have been distributed to its shareholders.

Deemed distributions are considered to have been received by the DISC's shareholders on the last day of the DISC's taxable year.¹²⁷

Actual Distributions

An actual distribution by a DISC out of earnings and profits is considered to have been made first, out of previously taxed income (i.e., earnings and profits deemed distributed), then out of accumulated DISC income, and finally out of other earnings and profits.¹²⁸ Since a distribution of previously taxed income is not subject to tax in the hands of the DISC's shareholders,¹²⁹ the 50 percent of the DISC's taxable income deemed distributed can be received without further Federal income tax. It would be advisable for the DISC to distribute its earnings and profits deemed to have been distributed, since retention of such earnings and profits in the DISC will require that they be invested in such a manner to satisfy the 95 percent assets test.¹³⁰ However, before paying out the DISC's earnings and profits deemed distributed, the shareholders should check the state income tax consequences since they may not parallel the federal treatment.

Actual distributions are considered to have been made after the deemed distributions for the year.¹³¹ Thus, an actual distribu-

127. INT. REV. CODE OF 1954, § 995(b); see note 19, *supra*.

128. INT. REV. CODE OF 1954, § 996(a)(1).

129. INT. REV. CODE OF 1954, § 996(a)(3).

130. Since the DISC's taxable income will not be finally determined under the intercompany pricing rules of section 994(a) until some time after the close of the DISC's taxable year, it will be difficult to determine precisely the amount of income which should be distributed as previously taxed income. Thus, to avoid the problem of having to invest previously taxed income in qualified export assets, the related supplier should maintain current estimates of the DISC's taxable income computed under section 994(a).

131. INT. REV. CODE OF 1954, § 996(c). A deficiency distribution is considered to have been made before any other actual distribution. See Proposed Treas. Reg. § 1.996-1(d).

tion by a DISC will not reduce the DISC's taxable income for the year for purposes of the 50 percent deemed distribution, regardless of the treatment of the actual distribution in the hands of the DISC's shareholders. For example, if a DISC has \$100,000 taxable income for the year and distributes \$60,000 to its shareholders, the distribution deemed to have been received from the DISC for the year is still \$50,000, and not \$20,000 (50 percent of \$40,000). However, at least \$50,000 of the \$60,000 actual distribution will not be taxable because it is a distribution of previously taxed income (i.e., the \$50,000 deemed distribution which preceded it), and, if the DISC has \$10,000 of undistributed earnings and profits deemed distributed in a prior year, the entire \$60,000 actual distribution will be tax-free.

Distributions on Disqualification

A shareholder of a corporation which is disqualified as a DISC, either because its DISC election has been revoked, or because it has failed to satisfy the 95 percent gross receipts test or the 95 percent assets test for the year (and has failed to make a deficiency distribution), is considered to have received a pro rata distribution, taxable as a dividend equal to the accumulated DISC income of the corporation.¹³² The accumulated DISC income is the corporation's earnings and profits derived during taxable years when it was a DISC which were not subject to taxation.¹³³ Thus, disqualification means the end of deferral, but it is the DISC's shareholders rather than the DISC which are subject to tax on the DISC's accumulated income.

However, the shareholders of the DISC are not taxed all at once on the accumulated income of a DISC which is disqualified. Rather, the distribution is spread out over a 10 year period (or shorter period if the corporation qualified as a DISC for less than 10 years) following the taxable year of disqualification.¹³⁴ For example, if a corporation qualifies as a DISC from 1972 through 1976, but is disqualified in 1977, its shareholders are required to report an equal amount of its accumulated tax-deferred income over the next five years, 1978 through 1982.

Gain on Dispositions of DISC Stock

Disposition of stock in a DISC will also trigger taxation of the DISC's accumulated tax-deferred income to the extent of the gain

132. INT. REV. CODE OF 1954, § 995(b)(2)(A).

133. INT. REV. CODE OF 1954, § 996(f); Proposed Treas. Reg. § 1.996-3(b).

134. INT. REV. CODE OF 1954, § 995(b)(2)(B).

recognized on the disposition and to the extent of DISC income accumulated while the shareholders held their stock in the DISC.¹³⁵ In certain dispositions where the gain is not recognized under some provision of the Code (such as a gift or an exchange pursuant to a "B" reorganization), the former shareholders of the DISC will not be subject to tax on the accumulated DISC income. In such case, the new owners of the DISC stock would step into the shoes of the former shareholders and the DISC would retain its status as a DISC.¹³⁶ However, where the separate corporate existence of the DISC is terminated (such as in a merger, asset acquisition or liquidation), then the former shareholders are subject to tax on the accumulated DISC income notwithstanding the fact that gain is not recognized.¹³⁷

There is no 10-year averaging of the gain on disposition of stock in a DISC, as in the case of the disqualification of a DISC. Thus, the gain would be taxable in full in the year of receipt or in the year of accrual, as the case may be.

Tax Treatment of Deemed or Actual Distributions

Deemed or actual distributions from a DISC, as well as distributions upon disqualification, are treated as a dividend by the DISC's shareholders. However, since the DISC is not subject to taxation, these dividend distributions are not entitled to the intercorporate dividends received deduction under section 243¹³⁸ and therefore will be fully taxable in the hands of the DISC's shareholders.¹³⁹

For purposes of the foreign tax credit, dividends from a DISC are treated as dividends from a foreign corporation to the extent they are treated as foreign source income.¹⁴⁰ A dividend from a

135. INT. REV. CODE OF 1954, § 995(c).

136. S. REP. NO. 437, *supra* note 2, at 114.

137. Proposed Treas. Reg. § 1.995-4(c)(2).

138. INT. REV. CODE OF 1954, § 246(d). The intercorporate dividends received deduction will be available to the extent the DISC makes a distribution out of earnings and profits other than accumulated DISC income or previously taxed income. Proposed Treas. Reg. § 1.246-4.

139. A DISC cannot be included in a consolidated income tax return. INT. REV. CODE OF 1954, § 1504(b)(7).

140. INT. REV. CODE OF 1954, § 901(d). For a more complete discussion of the foreign tax aspects of the DISC legislation than the one which fol-

DISC will be considered foreign source income to the extent attributable to qualified export receipts.¹⁴¹ Thus, a deficiency distribution will be treated as U.S. source income, and will not entitle a corporate shareholder of a DISC to an indirect foreign tax credit under section 902. However, most other forms of deemed or actual distributions will be treated as foreign source income, and therefore will give rise to a section 902 credit.

In practice, the availability of a section 902 credit is not likely to be of much benefit since, in most cases, a DISC will not be subject to foreign tax on its income. Moreover, a foreign source dividend from a DISC cannot be included in the numerator of the overall limitation on foreign tax credits under section 904(a), because a separate limitation on the foreign tax credits applicable to dividends from a DISC was added to the Code as part of the DISC legislation.¹⁴² Thus, to the extent export sales of the DISC's related supplier formerly generated foreign source income under the passage-of-title test, the effect of using a DISC may be to reduce the related supplier's available foreign tax credits.¹⁴³

Other questions will arise in connection with the character of a deemed or actual distribution of a DISC. Under section 996(g), distributions of a DISC received by a foreign shareholder will not be treated as a dividend, but rather as "effectively connected income" taxable at ordinary U.S. corporate rates. Moreover, the foreign shareholder of a DISC will be considered to have a permanent establishment in the United States so that it may not rely on an income tax treaty to avoid U.S. tax on the distribution from the DISC. In addition, it would appear that a distribution from a DISC will not be treated as a dividend for purposes of determining whether a corporate shareholder of a DISC is a personal holding company.¹⁴⁴ Instead, the distribution would have the same tax

laws, see Rendell, "Developments in Foreign Tax Credit: How it Affects Doing Business Abroad," 37 J. TAXATION 298, 302 (1972).

141. INT. REV. CODE OF 1954, § 861(a)(2)(D). An exception is made for distributions by a DISC attributable to producer's loans interest and gain on the disposition of nonrecognition property which are treated as U.S. source income.

142. INT. REV. CODE OF 1954, § 904(f).

143. In the case of a commission DISC, the impact on the foreign tax credit limitation of the related supplier would depend on the source of the deduction for the commission paid by the related supplier to the DISC. In the case of a buy-sell DISC, the related supplier may be able to significantly minimize the adverse effect on its foreign tax credit limitation by passing title to the goods sold to the DISC outside the United States.

144. The original Treasury Handbook on the DISC legislation so held. *Handbook*, *supra* note 53, at 31. However, the promised provision in the regulations has not yet appeared.

character in the hands of the corporate shareholder as it has in the hands of the DISC. However, for purposes of the maximum tax under section 1348, it would appear that a DISC distribution will be treated a dividend and not earned income, and therefore individual shareholders of the DISC will not be entitled to compute their tax on such distribution under section 1348.¹⁴⁵

EVALUATION OF THE DISC PROVISIONS

The Achilles heel of the DISC provisions is the lack of any ascertainable relationship between increased U.S. exports and the tax savings provided by the DISC incentive. Once the decision was made in 1971 not to put DISC on an incremental basis, this weakness was exposed to future critics of the DISC provision. The problem of demonstrating the effectiveness of DISC as an incentive for stimulating U.S. exports has been made more acute, if not insoluble, by the successive devaluations of the dollar, which will certainly add a significant boost to U.S. exports. Nevertheless, the Treasury is required to submit its first annual report to the Congress on April 15, 1974, setting forth an analysis of the "operation and effect" of the DISC provisions.¹⁴⁶ Congress is certain to look closely at this report, and the debate over the merits of the DISC concept may be renewed at that time. It would seem that if deferral of taxation on the foreign source income of foreign subsidiaries of U.S. corporations were severely curtailed or even eliminated as part of a tax reform package, much of the underpinning of the DISC legislation would collapse. On the other hand, supporters of DISC could argue that an incentive for U.S. exports was still needed to meet competition from foreign countries which provide other forms of tax relief to their exporters. To a great extent, the outcome of a renewal of the DISC debate will depend on the status of the U.S. balance of payments at that time.

As a tax incentive, the DISC provisions could be criticized as being overly complex. Next to Subpart F, the proposed DISC

145. In Proposed Treas. Reg. § 1.1348-3(a)(1), it is held that dividends from a Subchapter S corporation will not be treated as "earned income" for purposes of section 1348. This same rationale would appear to apply to dividends from a DISC. Such a holding would have an adverse effect on engineering or architectural proprietorships or partnerships which would be eligible to use a DISC.

146. Pub. L. No. 92-178, § 506.

regulations are the most intricate in the entire foreign tax area. This complexity is a function of the Treasury's desire to limit the DISC benefits to true exporting enterprises and to provide a special attraction in the form of the objective intercompany pricing rules. For the large manufacturing firms, the DISC provisions are not too complex. They have the large internal tax staffs and access to outside counsel which are necessary to effectively use the DISC provisions. However, small and medium sized firms may be discouraged by the complexity of DISC, and here some simplification is desirable. Such simplification could be achieved by providing 100 percent deferral on the first \$250,000 of DISC income, allowing producer's loans to be made of \$100,000 per annum without regard to the limitations presently contained in section 993(d), eliminating the fugitive capital rule for such producer's loans, allowing the intercompany pricing rules to be applied on a company-wide basis without regard to product lines, and eliminating the overall profit percentage limitation under marginal costing for sales under \$5,000,000.