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Domestic International Sales Corporations (Part II)

George J. Carey
Georgia State University College of Law, gcarey@gsu.edu

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DOMESTIC INTERNATONAL SALES CORPORATIONS

GEORGE CAREY*

TAXATION OF DISC INCOME TO SHAREHOLDER

While the income of a DISC is not subject to taxation when realized by the DISC, such income does not escape tax entirely. Generally, DISC income is taxable to the shareholders of the DISC under three circumstances; when it is actually distributed by the DISC to such shareholders; in the form of "deemed distributions" generally equal to one-half of the DISC's income in each year; and in the form of certain deemed distributions designed to encourage or discourage certain transactions or events. It is fairly clear that the designers of the DISC provisions intended that the deferral of taxation of DISC income should not be permanent, and that such income would eventually be taxed to the shareholders as ordinary income. As will be seen later herein, this is not necessarily the case.[157]

For each qualified year of the DISC, the shareholders are treated as having received a pro rata share, as of the last day of the taxable year of the DISC, of the following amounts: (1) gross interest paid to the DISC on producer's loans, (2) the lesser of the DISC's or its transferor's gain on certain property transferred to the DISC in a nonrecognition transaction, (3) one-half the taxable income of the DISC for the taxable year attributable to military property, (4) a portion of the DISC's taxable income for the year determined with reference to the DISC's failure to increase its exports over a base period, (5) one-half the excess of the taxable income of the DISC over the amounts described in (1), (2), (3), (4), and (5) foreign investment attributable to producer's loans.[158]

Deemed distributions for items other than increases in foreign investment attributable to producer's loans may not exceed the earnings and profits of the DISC for the year with respect to which the distribution is made.[159]

157. *See generally* I.R.C. § 995 and Treas. Reg. §§ 1.995-1 through 1.995-5. Unless otherwise indicated, any sections or regulations referred to are to be found in the Internal Revenue Code and Treasury Regulations of 1954.

158. I.R.C. §§ 995(b), Treas, Reg. § 1.995- 2(a). The Tax Reform Act of 1976, Pub. L. 94-455, 90 Stat. 1520, added the deemed distributions for income from military property and for failure to increase exports.

159. A technical ambiguity was created by the Tax Reform Act of 1976, which amended section 995(b)(1) by adding two new categories of deemed distributions (for income from military property, and for failure to increase exports). The general rule under section 995(b)(1) is that a deemed distribution is not made if there are insufficient earnings and profits for the year to cover it (with regard to the ordering rules of section 996). A special rule is provided in the flush language, following the list of deemed distributions in section 995(b)(1) (the last was (E) and is now (G)), to the effect that accumulated, as well as current year, earnings and profits are taken into account "in the case of a distribution described in subparagraph (E)." Subpara-

Apparently, earnings and profits from prior years of the DISC are not taken into account for this purpose, and would, thus, not add to the amount which would be deemed distributed. The regulations presently provide that deemed distributions for increases in foreign investment attributable to producer's loans may not exceed the lower of accumulated earnings and profits of the DISC at the beginning of its taxable year or accumulated DISC income as of the beginning of the year, plus the excess of the current year's earnings and profits over the distributions described in (1), (2), and (3) above. Presumably, the regulations will be changed to treat distributions under (3) and (4), in the same way. A deficit in the current year's earnings and profits reduces the accumulated figures for the beginning of the year. Thus, if all earnings and profits of the current year are deemed distributed because of the amounts in (1), (2) and (5) (and, presumably, (3) and (4)), foreign investment by a borrower of a producer's loan will cause deemed distributions only if the DISC has accumulated earnings and profits or accumulated DISC income, and, presumably, this treatment would follow even if there were no (1) through (5) distributions for the year, because there was no current year earnings and profits.[160]

Should the current year's earnings and profits be insufficient to support deemed distribution of all amounts other than producer's loan foreign investment, the present regulations provide an ordering rule. First, gross interest from producer's loans, second, gain on dispositions by the DISC of nonrecognition non-QEA property, and third, gain on disposition by the DISC of nonrecognition QEA property, are deemed distributed. If current year earnings and profits are insufficient to support all such distributions, all of one category is distributed before moving on to the next. Only after deemed distributions for all these amounts are added, is the deemed distribution of one-half the excess of the DISC's taxable income over the preceding amounts made.[161]

As noted above, where a DISC received property in a transaction in which gain of the transferor is realized but not recognized, gain recognized by the DISC upon its disposition of the property triggers a deemed distribution, equal to the lesser of the gain of the DISC's transferor which was not recognized, or the gain of the DISC on its disposition. For example, if property with a basis of 10 and a fair market value of 20 was transferred to the DISC in a section 351 exchange for 20 of DISC stock, and the DISC later sold such property for 30, there would be a deemed distribution of 10—

graph (E) used to be deemed distributions for increase in foreign investment attributable to producer's loans, but is now the deemed distribution for failure to increase exports. I assume the failure to change the reference in the flush language was an oversight, and will treat that language as though it referred to subparagraph (G).

160. Treas. Reg. § 1.995-2(b). (assuming it is amended as indicated)

161. *Id.* § 1.995-1(b)(3). These ordering rules will have to be changed to reflect the new categories of deemed distributions added by the 1976 Act.

because the gain of the DISC on its sale of the property (20, 30-10) was greater than the unrecognized gain of the transferor (10, 20-10) on its transfer to the DISC. Deemed distributions are made for nonrecognition property whether or not it is QEA, but in the case of QEA, such treatment does not apply to stock in trade or property described in section 1221 (1).[162]

If property received by a DISC in a nonrecognition transaction (hereinafter, tainted property) is transferred to a second DISC, in a transaction in which the transferor does not recognize gain, the taint stays with the property in the hands of the second DISC. If tainted property is transferred for new property, to a person other than a DISC, the taint carries over to the new property in the hands of the transferor DISC. Where gain in partly recognized on a transfer by a DISC of tainted property, the taint, whether carried over to a transferee DISC or to new property in the hands of the transferor DISC, is reduced to the extent of such recognition. It is not clear, where tainted property is transferred in exchange for other property in a nonrecognition transaction to another DISC, whether the property received by the transferor DISC is tainted as well as the property transferred to the second DISC. For example, if DISC one received property in a section 351 exchange which it in turn transfers to DISC two in a second section 351 exchange for stock of DISC two, it is not clear whether the DISC two stock in the hands of DISC one would or would not be tainted. It would appear that it would not.[163]

Since deemed distributions are treated as made on the last day of the taxable year of the DISC, it is possible to increase somewhat the deferral implicit in the DISC provisions by choosing a taxable year for the DISC which ends with the last day of the first month of the taxable year of the shareholder. In this way, the shareholder will not be required to show the regular deemed distributions from the DISC as taxable income, on its regular income tax return, until thirteen and one-half months (in the case of a corporate shareholder) after the close of the taxable year of the DISC. Since regular deemed distributions increase previously taxed income of the DISC, and since regular deemed distributions of the DISC's income (those described in (3) above) are generally treated as made before other distributions of the DISC, it is possible to actually distribute the amount treated as deemed distributed, without paying tax on it, until more than one year later than the day the actual distribution is made. For example, if the DISC had no interest on producer's loans, gain on property received in a nonrecognition transaction or deemed distribution for failure to increase exports, and had taxable income of 100, one-half this amount, or 50, would be deemed distributed to the shareholder of the DISC, on the last day of the taxable year of the DISC. If such last day was on the last day of the first month of the

162. *Id.* § 1.995-2(d) and § 995(c).
163. *Id.* § 1.995-2(d)(2) and (3).

taxable year of the shareholder, the deemed distribution would not show up on the regular tax return of the shareholder, for the taxable year in which the distribution was made, until 13½ months later (corporate shareholder). If on the last day of the taxable year of the DISC, for which the distribution is treated as made, an actual distribution in the same amount, 50, was made, such actual distribution would be treated as made from "previously taxed income" of the DISC (which would have been increased by the amount of the deemed distribution) and, thus, would not be taxed again to the shareholder. Thus, the shareholder would have the use of the amount distributed for approximately one year before being required to pay tax on it.[164]

Because of the structure for the distribution of DISC income, substantial tax planning opportunities are available.[165] Because deemed distributions are treated as made pro rata to the DISC's shareholders, while the producer's loan and section 994 pricing mechanisms are not based on direct shareholdings, it is easily possible to shift income from one taxpayer to another, or to avoid paying tax on income at the corporate level. Thus, for example, if a closely-held corporation engaged in substantial export operations, it could achieve distribution of the income from its export operations to its shareholders by arranging for them to purchase stock in a DISC. Either by channeling sales through the DISC, or by borrowing money from the DISC in the form of producer's loans, income would be shifted out of the corporation, through the DISC, and to the shareholders in the form of deemed distributions. Since deemed distributions for interest on producer's loans, or the regular deemed distribution of taxable income of the DISC, increase previously taxed income and are treated as made before actual distributions, as noted above, an actual distribution of the amounts deemed distributed would result in only one tax to the shareholder. The closely-held corporation, of course, would pay no tax on the income of the DISC, unless it held stock in such DISC. Since the DISC is not in any case taxed on its own income, tax at the corporate level would be entirely avoided.[166]

It is also possible to shift income from one controlled entity to another. Thus, if corporations A and B are commonly controlled by corporation X, and if A makes a DISC election, by contributing the stock of A to B, X will shift a substantial portion of its export income, on sales channeled through A to B, in the form of deemed distributions from A of export earnings. This could be particularly useful where accumulated earnings or personal holding company tax problems were present.[167]

164. *Id.* § 1.995-2(a). (flush language preceding (1))

165. For a more extended treatment, *see* Bischel, *Proposed DISC Regs: Planning for Deemed and Actual Distributions in Qualified Years*, 39 J. OF TAX, 178 (1973) [hereinafter cited as Bischel].

166. *Id.*

167. *Id.*

A. *Deemed Distribution for Failure to Increase Exports*

The Tax Reform Act of 1976 adds a complex group of provisions designed to limit DISC benefits, to the increase in exports through the DISC over the exports for a base period. Generally, the limitation is structured as a deemed distribution of the same percentage of the current year's income as the base period gross export receipts is of the current year's export gross receipts. Thus, the larger the present year's export receipts are in relation to the base period receipts, the smaller the percentage, and the smaller the portion of current taxable income of the DISC is deemed distributed. There are, of course, a number of limitations which considerably reduce the impact of this incremental limitation, perhaps the most important of which is that only sixty-seven percent of the average of the base period export gross receipts is taken into account. With this limitation, some DISC benefits would be allowed even if export gross receipts remained constant for many years.[168]

"Export Gross Receipts" is defined, by the new section 995 (e) (4), as receipts described in section 993 (a) (1), but excluding receipts from sale of QEA, other than export property, distributions from related foreign export corporations, and interest on QEA debt obligations.

The base period for taxable years beginning before 1980 is 1972, 1973, 1974, and 1975. For taxable years beginning after 1980, the base period moves forward one year each year.[169] Only sixty-seven percent of such average is taken into account and export receipts from sales of property which was eliminated from DISC benefits by section 993 (c) (2) is excluded from the receipts for the base period years.[170] If a DISC was not in existence for one of the years of the base period, or was not a DISC for such year, the export receipts figure for such year is zero.[171]

After base period export gross receipts have been determined and averaged, the average is multiplied by sixty-seven percent. This amount is the numerator, and export receipts for the current year is the denominator. This fraction is then applied to the adjusted taxable income of the DISC for the taxable year, which is the regular taxable income of the DISC for the taxable

168. I.R.C. §§ 995 (e), (f), and (g), as added by the Tax Reform Act of 1976.

169. *Id.* § 995 (e) (5) (amended 1977).

170. *Id* § 995 (e) (3). This last provision deals with the situation where property did qualify for DISC benefits, when DISC was first enacted, but such property was later disqualified (*e.g.*, depletion allowance property). Apparently Congress had in mind the situation of a DISC which realized a large portion of its receipts, in the early years of the DISC provisions, from exports of minerals. Absent a special rule, these DISCs would have large export gross receipts for 1972, 1973, and 1974, from sales of such minerals, and a big decrease in export gross receipts for 1975 and later years. Since the base period years, until 1980, are 1972, 1973, 1974, and 1975, even if these DISCs increased their exports of other property for 1975 and after, they would have to make up the sales which had been disqualified before they would even get back to ground zero under the formula.

171. *Id.* § 995 (e) (6).

year, reduced by the deemed distributions for gross producer's loan interest, gain on nonrecognition property, and one-half the taxable income of the DISC derived from sales of military property. The resulting amount is deemed distributed to the shareholders of the DISC, and is deemed distributed before the regular deemed distribution of one-half the DISC income is computed.[172]

A number of special rules are provided to deal with situations such as controlled groups and short taxable years. Presumably, these will be considerably expanded by regulations.[173]

The new section 995 (f) provides a special exception from the incremental limitation for small DISCs, generally those with adjusted taxable income (as defined above) less than $100,000. The exception phases out at $150,000 adjusted taxable income.

B. *Deemed Distribution for Military Property*

The new section 995 (b) (1) (D) adds a deemed distribution for one-half the DISC's income attributable to military property. There will, undoubtedly, be a number of questions to be resolved in the interpretation of this provision, not the least of which will be whether income from services which are related and subsidiary to a sale of military property will be deemed distributed under this provision.

C. *Distributions Upon Disqualification*

If a DISC fails to qualify, or terminates its election, the accumulated DISC income (generally, the portion of the income of the DISC which has not been taxed to the shareholders) as of the last day of the taxable year the DISC last qualified, is deemed distributed to the shareholders. Such distributions are treated as made ratably on the last day of each of the ten years of the former DISC, beginning with the first disqualification year, or over twice the number of consecutive years for which the DISC was qualified, immediately before such first year of disqualification, whichever is less. Such distributions are pro rata, and are treated as made to the person who held stock of the DISC outstanding on the last day of the last qualification year, whether or not such person held stock when the income of the DISC was earned, or for that matter at any other particular time (this should be contrasted with the treatment of gain on disposition of DISC stock under section 995 (c)). If a shareholder disposes of his stock after DISC status terminates, his transferee includes these deemed distributions after such transfer; but, their amount is reduced if gain of the disposing shareholder is treated, in whole or part, as a dividend under section 995 (c).[174]

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172. *Id.* §§ 995 (e) (1) and (2); § 995 (b) (1) (F).
173. *Id.* §§ 995 (e) (7) through (10); § 995 (g).
174. Treas. Reg. § 1.995-3.

Actual distributions from the former DISC, during the time the deemed distributions are treated as being made, will reduce the last installment to be made, and then other installments in reverse order. Thus, if 100 will be deemed distributed over ten years, and an actual distribution of 50 is made, 10 is deemed distributed in each of the first five years, but 0 will be deemed distributed thereafter. If there is more than one group of consecutive qualified years, broken by disqualified years, separate deemed distributions are made for each group of consecutive qualified years. For example, if a calendar year DISC was qualified for 1975, 1976, and 1977, disqualified for 1978 but qualified for 1979 and 1980 and then disqualified for 1981, the accumulated DISC income as of December 31, 1977, would be deemed distributed in six installments on December 31, 1978, 1979, 1980, 1981, 1982, and 1983. The accumulated DISC income as of December 31, 1980, would be deemed distributed on December 31, 1981, 1982, 1983, and 1984. If shareholder A transferred his DISC stock to shareholder B on December 1, 1978, B would include the deemed distributions for 1978 and future years. But, if A transferred such stock on January 15, 1979, A would include the deemed distribution for 1978, and B would include all the deemed distribution for 1979. Apparently, there is no provision for fractionalizing a deemed distribution for a particular year, where stock has been transferred, between transferee and transferor. [175]

D. *Gain on Disposition of DISC Stock*

If there was no section 995 (c) it would be possible for a shareholder to realize accumulated DISC income as capital gain, rather than ordinary income, by selling the stock of the DISC. Presumably, in such a case the amount received for the stock would reflect the accumulated income of the DISC, and the basis of the stock in the hands of the transferee would be the amount of such purchase price. Thus, a liquidation without recognition of that portion of the price which represented the income could result. To prevent this, section 995 (c) and 1.995-4 treat any recognized gain on a disposition of DISC stock as a dividend from the DISC, to the extent of the accumulated DISC income attributable to the period during which the disposing shareholder held such stock. In effect, the portion of the price received attributable to the untaxed portion of the DISC's income is treated as received by the selling shareholder, when he is paid by the buyer.

A similar rule applies where the corporate existence of the DISC is terminated, while it still has income earned in qualified years which has not been taxed to the shareholders. In such case, however, since the existence of the DISC itself ceases, it is necessary not only to deal with recognized gain, but also to force recognition, since certain forms of liquidation do not

175. *Id.* § 1.995-3(e).

involve recognition of gain. Here, too, the accumulated DISC income is treated as distributed as a dividend, and, again, to the extent of the gain.[176]

In the case of disposition of DISC stock, section 995 (c) generally does not trigger recognition; it merely characterizes gain recognized under other provisions of the Code. To meet certain abuse possibilities, the 1976 Act provided for forced recognition in some cases. Section 995 also does not apply to gain treated under other Code sections as ordinary income: its sole function is to characterize recognized gain as ordinary income, rather than capital gain. For example, if the stock of a DISC is disposed of as a gift, section 995 (c) would not apply, because no gain would be recognized.[177]

Where stock of a DISC is disposed of in a transaction in which the separate existence of the DISC is terminated, and gain is realized but not recognized, gain is recognized under section 995 (c) and treated as a dividend from the DISC—but only to the extent gain is not recognized under other Code provisions, and only to the extent of accumulated DISC income attributable to the time the shareholder held such stock in the DISC.[178]

Generally, the separate existence of the DISC will be considered terminated only if there is no DISC or former DISC to which the income of the DISC is carried over. For example, if under section 381 (a) the attributes of an acquired DISC were carried over to a corporation which was a DISC immediately after the acquisition, the separate existence of the acquired DISC would not be considered terminated. An example of a case where the separate existence of the DISC would be terminated is a section 332 liquidation.[179]

Recognition or characterization of gain, under section 995 (c), is limited by the accumulated DISC income attributable to the time the shareholder held the stock of the DISC. Regulation 1.995-4 (d) provides that such holding period is determined under section 1223. Thus, section 995 (c) may not be avoided by a transfer to another person, in a nonrecognition exchange in which the basis of the new property is determined with reference to the basis of the DISC stock, or by a gift. In such case, since the holding period of the DISC stock is determined under section 1223, and since under that section the holding period of the property exchanged for the DISC stock would be "tacked" to the period for which the DISC stock was actually held by such transferee, the transferee would be treated as having held the DISC stock for the same period as the transferor actually held such stock, and the DISC income attributable to such period would remain with the stock for section 995 (c) purposes.[180]

176. I.R.C. § 993 (c); Treas. Reg. § 1.995-4.
177. Treas. Reg. § 1.995-4 (b) (2).
178. Treas. Reg. § 1.995-4 (c) (2).
179. *Id.*
180. *Id.* § 1.995-4 (d).

In determining DISC income attributable to the period of time the shareholder held the stock, the increase in accumulated DISC income from the beginning to the end of the year is apportioned to the outstanding shares of the DISC for the year, on a daily basis. Thus, if stock is transferred during a year, an allocation of the increase in accumulated DISC income for the year, would be made on the basis of the number of days the new shareholder held the stock.[181]

E. *Gain on Disposition of Property by the DISC*

As noted above, gain realized by the DISC on its disposition of an asset, received by it in a nonrecognition transaction, is deemed distributed to the shareholder under section 995 (b) (1) (B) and (C).[182] Generally, section 995 (b) (1) (B) applies to property other than QEA in the hands of the DISC, and only to the extent of the gain which would have been recognized by the transferor to the DISC, or the gain recognized by the DISC on its transfer, whichever is less. Section 995 (b) (1) (C) is narrow, and applies to property (including QEA) in the hands of the DISC, but not including stock in trade or other section 1221 (1) property. It only causes a deemed distribution to the extent the transferor to the DISC would have realized ordinary income on the transfer to the DISC, had it been recognized, or the gain of the DISC on its disposition of the property, whichever is less. Section 995 (b) (1) (C) is narrower, applies to property (including QEA in the hands of the DISC), but not including stock in trade or other section 1221 (1) property. It only causes a deemed distribution to the extent the transferor to the DISC would have realized ordinary income on the transfer to the DISC, had it been recognized, or the gain of the DISC on its disposition of the property, whichever is less.

Thus, the purposes of the two provisions are quite different. Section 995 (b) (1) (B) appears designed to prevent use of the DISC as a conduit for property which is not to be used by the DISC, but is being channeled through it only to reduce the taxation of gain. Since section 995 (b) (1) (B) does not apply to QEA, it does not apply to export property, and thus is really related to section 992(a)(1)(A), which requires ninety-five percent of the gross receipts of the DISC to be QEA. Section 995 (b) (1) (C), on the other hand, appears designed to prevent use of sales through the DISC as a way around depreciation recapture, since it is limited to gain which would have been treated as ordinary income to the transferor to the DISC.

Because section 995 (b) (1) (B) is limited to a "sale or exchange" by the DISC, it is possible its provisions may be avoided by careful planning. The key to such avoidance is a disposition, by the DISC, which is not treated as a "sale or exchange". For example, if property with a basis of 100 and a fair

181. *Id.*
182. *Supra* text at note 162. *See generally* Bischel, *supra* note 165.

market value of 500 is transfered to the DISC in a section 351 exchange and retained until the previously taxed income of the DISC is in excess of that amount, and is then actually distributed by the DISC to the shareholder, the distribution would be treated as a dividend, and thus not as a "sale or exchange." Under section 996 (a) (1) (A), it would be treated as from previously taxed income, and thus not taxable to the shareholder. The shareholder would have a basis in the property equal to its fair market value, under section 997 (1), and thus would realize no gain if the property was immediately sold.[183]

Before the Tax Reform Act of 1976, it was possible to avoid the application of section 995 (c), through the use of transactions fitting within sections 336, 337, and 311. An amendment to section 995 (c) now forces recognition in such cases.

FOREIGN INVESTMENT ATTRIBUTABLE TO PRODUCER'S LOANS[184]

The apparent policy underlying favorable treatment for producer's loans by a DISC is encouragement of domestic investment in manufacturing and other production facilities. Consistent with this policy, the investment of sums abroad is discouraged, through the mechanism of deemed distributions. Generally, increases in foreign investments of the controlled group which includes the DISC, are deemed distributed each year, to the extent of producer's loans by the DISC to members of the group which experienced such increases.[185]

It should be noted that the amounts taken into account are determined on a cumulative basis; that is, total net increase or decrease in foreign investment over the amount as of December 31, 1971, is taken into account as of the end of each year, even though the portion of that increase attributable to a previous year may already have been taken into account. Similarly, the limit on the amount of deemed distributions for outstanding producer's loans applies to the cumulative total of producer's loans, as of the end of each taxable year, even though a portion of such total may have been taken into account in a previous year. This cumulation, however, is generally offset by subtracting all previous deemed distributions for increases in foreign investment, so there should be little doubling of deemed distributions for a particular amount of foreign investment, or for particular producer's loans.[186]

There are generally four limitations on the amount of deemed distributions for foreign investment. The amount deemed distributed is (1) the

183. *Id.*
184. *See generally* Norman, *The 'Fugitive Capital Rule' for DISCs: Working with it and Planning to Avoid It*, 40 J. OF TAX. 234 (1974).
185. I.R.C. §§ 995 (b) (1) (E) and (d); Treas. Reg. § 1.995-5.
186. Treas. Reg. § 1.995-5 (a) (6).

smallest of: (a) the earnings and profits of the DISC available for such distributions, (b) the net increase in foreign assets, (c) the actual foreign investment, or (d) outstanding producer's loans of the DISC to members of its controlled group after December 31, 1971; and (2) reduced by the amount of all previous deemed distributions for foreign investment. Apparently, the distributions of each DISC are determined separately, and deemed distributions are no longer taken into account after a DISC ceases to exist.[187]

In arriving at the amounts of the above limitations, items with respect to all members of the controlled group which includes the DISC, domestic and foreign, are taken into account. It should be noted that a loan by the DISC to a person not a member of its controlled group could have substantially different results. It is very unclear whether such non-group loans were contemplated by proposed 1.995-5(a)(1), or the statute, for the definitions of the amounts which determine the amounts of foreign investment and other limitations were expressed solely in terms of the controlled group, which includes the DISC. This created an ambiguity, which could be resolved in two ways: (1) read the language of section 995 (d) literally to apply only to amounts with respect to members of the controlled group which includes the DISC, in which case there would literally never be a deemed distribution for foreign investment of producer's loans if the DISC had made no loans to members of *its* controlled group (*e.g.*, section 995 (d) (1) (A), (B), and (C) each refer to amounts by "the group" or "such group," in each case clearly referring to the controlled group of the DISC—see section 995 (d) (1) (A) "which includes the DISC"); thus, under this reading, if the DISC loaned $1,000,000 to a person only forty-nine percent commonly controlled, and that person immediately loaned the money (perhaps to a member of the DISC's controlled group?) or purchased assets abroad, section 995 (d) would not apply, and there would be no deemed distribution for foreign investment; or (2) apply the language by analogy and compute the amounts involved with reference to the members of the controlled group of the borrower, or at least with respect to the borrower itself. The final regulations added language in effect limiting section 995 (d) to members of the DISC's group.[188] Failure to apply section 995 (d) to nonmembers of the controlled group of the DISC makes a nullity of the policy of section 995 (d), to limit the use of the tax deferred income of the DISC as a means of financing foreign operations. With respect to members of the controlled group, that term is defined as in section 1563 (a), except that fifty percent is substituted for eighty percent.

Because different members of the group may have different taxable years, the regulations provide that the determinations of foreign investment, and

187. *Id.* § 1.995-5 (a) (1).
188. *Id.* § 1.995-5 (a) (2) (i) (*c*).

other related matters, are made with respect to the taxable years of the members, ending with or within the taxable years of the DISC. Thus, if the taxable year of one member ended on November 30, and the DISC used a calendar year, the relevant figures for the member's taxable year ending November 30, 1974, would be used with respect to the taxable year of the DISC ending December 31, 1974. Under this approach it is not necessary to fractionalize taxable years, and considerable complexity is avoided. Where the DISC has a short taxable year because it is changing its taxable year, for example under 1.991-1 (b) (3), the year of the DISC is such short period, and the years of the members of the group are the years ending within such short period. Where the DISC begins its existence after the beginning of the taxable year it has chosen (for example, if the DISC elects a calendar year but does not come into existence until February 1), a taxable year is constructed to run from twelve months before the end of the DISC's first taxable year. For example, if as above the DISC did not come into existence until February 1, but had elected a calendar year, figures for members' years ending after January 1 (because that is twelve months before the end of the first taxable year of the DISC, which ends on December 31) would be taken into account.[189]

Unless an election to take only three years into account is made, all relevant figures for taxable years of members ending after December 31, 1971, are taken into account with respect to such members, even though the DISC did not exist, or had not elected to be a DISC before some time after that. The regulations provide that the years of the members for periods prior to existence or election of the DISC, for purposes of the relevant calculations, are the years created by extending backwards the year the DISC chooses for its first taxable years. Thus, for example, if an existing corporation elects to be treated as a DISC, and had been on a June 30 fiscal year, but elected a calendar year for its first DISC taxable year, the years previous to the election would be reconstructed on a calendar year basis. Thus, if a member of the group whose taxable year ended July 31 had made a foreign investment on March 15 of the year in which the DISC elected, such amount would be taken into account for the first taxable year of the DISC, which would run from January 1 of the year of the election to December 31 of such year, for this purpose.[190]

The amount treated as the net increase in foreign assets is generally the amount invested by all members of the group since December 31, 1971, in assets described in section 1231 (b), located outside the United States. Items which are QEA, or would be QEA if held by the DISC, are excluded. Property is treated as located outside the United States if it is used predominantly outside the United States. Money is not included, and where property

189. *Id.* § 1.995-5 (a) (3).
190. *Id.* § 1.995-5 (a) (4).

which would have been treated as a foreign asset for this purpose (or was so considered for a prior year) was sold, the amount received is subtracted from the amount for such foreign assets.[191]

Several offsets are allowed against foreign assets in determining net foreign assets. Depreciation for assets included above offsets foreign assets' but only if the asset is or would be considered a foreign asset for these purposes. For example, if a foreign member purchased an asset during a taxable year which ended before January 1, 1972, depreciation on such asset for a taxable year ending after December 31, 1971, would be taken into account as an offset. Such depreciation would not be taken into account if the asset was excluded from foreign assets, because it is (or would be in the hands of a DISC) QEA. Generally, only straight line depreciation is allowed for this purpose, to a domestic member of the group, and additional first year depreciation under section 179 is not allowed. If an asset is owned by a foreign member of the group, depreciation is the amount allowable under regulations 1.964-1, for determining the earnings and profits of a controlled foreign corporation. Depletion is also allowed as an offset, but is limited to cost depletion under sections 611 and 612.[192]

Stock and debt obligations of any member of the group, either issued or sold by a member of the group after December 31, 1971, is allowed as an offset. The amount taken into account is the amount received for such stock or debt. Only stock and debt sold to non-United States persons, who are not members of the group, are taken into account. It is not necessary that the stock or debt be sold by the issuer. For example, one member of the group may have sold its stock to another member before December 31, 1971, and the purchasing member may have sold such stock to a foreign nonmember after December 31, 1971, in which case the amount received for the stock would be an offset. To prevent manipulation of the offset, debt obligations are taken into account only if they were not repaid within twelve months after issuance.[193]

One-half the total earnings and profits of foreign members of the group which are controlled foreign corporations, and one-half the earnings and profits of foreign branches of domestic members of the group, are also allowed as an offset. These determinations are made without regard to any distributions which reduce earnings and profits (it should be recalled that items are determined throughout on a cumulative basis), and are made by applying the rules of regulations 1.964-1. Amounts less than zero are not taken into account, so an overall deficit in earnings and profits is ignored.[194]

1.995-5 (b) (7) permits an offset for certain financing under the Foreign

191. *Id.* § 1.995-1 (b).
192. *Id.* § 1.995-5 (b) (2) through (7).
193. *Id.* § 1.995-5 (b) (4).
194. *Id.* § 1.995-5 (b) (5).

Direct Investment Control Program. Presumably the elimination of such controls will gradually reduce the importance of this offset.[195]

If the DISC so elects, amounts taken into account as foreign assets, and offsets against them, may be determined only for the three years preceding the year of each member of the group in which the DISC first elected. For example, if a DISC first elected DISC treatment for calendar year 1980, and corporation X was a member of the DISC's group, with a taxable year ending June 30, the DISC could elect to take into account for X only relevant items for X's taxable years ending June 30, 1977, 1978, and 1979, rather than taking into account all items after December 31, 1971. X's items for its years ending June 30, 1980, and thereafter, would be added to the cumulation, year-by-year, as usual.[196]

Actual foreign investment is the sum of stock or debt of foreign members of the group acquired by domestic members after December 31, 1971, transfers by domestic members of money or property to foreign members (or foreign branches of domestic members), and one-half the earnings and profits of foreign members which are controlled foreign corporations (and of foreign branches of domestic members) accumulated for taxable years beginning after December 31, 1971 (unreduced for distributions).[197]

Where a controlled group includes two or more DISCs, the items taken into account as foreign investment attributable to producer's loans are allocated between such DISCs by a fraction, the numerator of which is the producer's loans to members of the group, by one DISC, and the denominator of which is the total producer's loans to members of the group, by all such DISCs. If such DISCs have different taxable years, they must select the taxable year of one of them for purposes of the computations.[198]

TREATMENT OF DISTRIBUTIONS OF A DISC

Generally, actual distributions by a DISC from the portion of its income which has been deemed distributed to the shareholders are not taxable to them a second time, but distributions which are from either the portion of the income of the DISC which elected and not yet taxed to shareholders, or earned by the corporation before it elected DISC status, are taxable as dividends under the usual rules of the Code. For this reason, it is necessary to determine the kind of income which is being distributed by the DISC, and the amount of each kind which the DISC holds. Generally, actual distributions are treated as made first from previously taxed income (the portion of the DISC's income which was taxed to the shareholders are deemed distri-

195. *Id.* § 1.995-5 (b) (7).
196. *Id.* § 1.995-5 (a) (5).
197. *Id.* § 1.995-5 (c).
198. *Id.* § 1.995-5 (g).

butions, thus not taxable when later actally distributed), secondly, from accumulated DISC income (the portion of the DISC's income which was not deemed distributed to the shareholders, and thus is taxable to them when distributed, though for which no dividends received deduction is allowed), and finally, from other earnings and profits (income earned by the corporation before DISC status, thus taxable to the shareholders when distributed, and for which a dividends received deductions is allowed). These rules assume the actual distribution is from the earnings and profits of the DISC. It is not entirely clear what result follows from a distribution in excess of earnings and profits. Presumably, such distribution would be tax free to shareholders, to the extent of the basis of their stock, and treated as capital gain to the extent of any excess over basis.[199]

Section 996 (c) provides that distributions shall be treated as made in the following order: first, deemed distributions; second, actual distributions to cure a failure to qualify under the ninety five percent QEA and QER tests; third, other actual distributions. The amount of a deemed distribution apparently does not decrease earnings and profits on the DISC,[200] and such distributions increase the previously taxed income account of the DISC. One-half of an actual distribution to cure failure to qualify under the ninety five percent QEA and QER tests, and deemed distributions for increases in foreign investment attributable to producer's loans, are treated as made, to the extent of earnings and profits, first from accumulated DISC income, secondly, from other earnings and profits, and, finally, from previously taxed income.[201]

There are various permutations and combinations possible under these rules, as they interact. One of the more important possibilities is the reversal of order of the accounts from which actual qualifying distributions are treated as made, as compared to other actual distributions. The latter are treated as made first from previously taxed income, and, secondly, from accumulated DISC income: thus, such distributions usually will not be taxable to shareholders, since deemed distributions for the year of such actual distribution will have been treated as made first under section 996 (c), and will have increased previously taxed income under section 996 (f) (2). One-half of actual qualifying distributions, on the other hand, are treated under section 996 (a) (2) as made first from accumulated DISC income,

199. I.R.C. § 996; Treas. Reg. § 1.996-1.

200. Except, that is, as described in the text at note 161 *supra*.

201. Treas. Reg. § 1.996-1. To avoid "double counting", that is, taking the same amount into account twice, once as an actual distribution to qualify under section 992 (a) (1) (A), and again as one-half the DISC's taxable income under section 995 (b) (1) (F), the 1976 Act amended section 996 (a) (2) to provide that an actual distribution, to qualify, is treated one-half as coming first from previously taxed income, and one-half as coming first from accumulated DISC income. Since distributions from previously taxed income are not taxable to the DISC's shareholders, one-half the qualifying distribution will be tax free, and, thus, only one-half the actual distribution will be counted twice. I.R.C. § 996 (a) (2) (*as amended* 1977).

secondly, out of other earnings and profits, and, finally, out of previously taxed income. Thus, for an actual qualifying distribution to be completely tax-free, the entire accumulated DISC income, and other earnings and profits accounts of the DISC, must have been exhausted—a contingency which does not seem likely.

Since deemed distributions, including the regular deemed distribution (generally of one-half the DISC taxable income for the year under section 995 (b) (1) (D)) increase previously taxed income under section 996 (f) (2), and are treated as made before other distributions for the year under section 996 (c), it is to be expected that a DISC will distribute at the end of its year the amount treated as deemed distributed for that year, since it may do so without further tax consequences to its shareholders.

If shares of stock in a DISC are transferred before the end of a taxable year of the DISC, the transferor is taxable on actual distributions made before such transfer, but is not taxable on actual distributions made after the transfer, or deemed distributions treated as made at the end of the DISC's year.[202]

Deficits in earnings and profits for a taxable year are generally charged first to other earnings and profits, secondly, to accumulated DISC income, and finally, to previously taxed income. If the earnings and profits deficit is greater than the sum of these three accounts, a deficit is created in the other earnings and profits account, but no deficit is created in accumulated DISC income, or previously taxed income accounts. Where a DISC is disqualified, a deficit in earnings and profits has no effect on the amount of accumulated DISC income treated as distributed in each of the ten (or fewer) years following the last year of DISC status under section 995 (b) (2).[203]

It should be noted that the accounts discussed above are earnings and profits accounts, and are, thus, not necessarily fully reflective of amounts of taxable income of the DISC.

The earnings and profits account described as "accumulated DISC income" is, generally, the amount of the accumulated DISC income as of the close of the previous taxable year, increased by the amount of "DISC income" for the current year, and decreased for certain deemed and actual distributions for the current year. "DISC income" for this purpose is the earnings and profits of the DISC for the current year, less the regular automatic deemed distribution under section 995 (b) (1) (F). The reductions of the resulting amount are for deemed distributions in the years following termination of DISC status (section 995 (b) (2)), deemed distributions for foreign investment attributable to producer's loans, certain adjustments to the DISC's income for transactions subject to section 995 (c), actual distri-

202. I.R.C. § 996.
203. Treas. Reg. § 1.996-2.

butions to cure failure to qualify under the ninety five percent QEA and QER tests, and, then, other actual distributions.[204]

The earnings and profits account referred to as "previously taxed income" is, generally, the amount of previously taxed income as of the close of the previous taxable year, increased by the deemed distributions under section 995 for years following termination of DISC status, less actual distributions to cure failure to meet the ninety five percent QEA and QER tests, then, other actual distributions.[205]

The earnings and profits account referred to as "other earnings and profits" is, generally, amounts other than those described as accumulated DISC income and previously taxed income, and thus will consist of earnings and profits accumulated in years when the corporation failed to qualify as a DISC. This account is reduced to the extent distributions are treated as coming from it, and for deficits in earnings and profits.[206]

Generally, where a shareholder recognized gain on a disposition of DISC stock under section 995 (c), and a later actual distribution is made by the DISC to the transferee of such shareholder (or a distribution is deemed made in the years following termination of DISC status under section 995 (b) (2)) out of accumulated DISC income, such distribution is treated as made out of previously taxed income, to the extent of the gain so recognized. This treatment, however, does not apply to redemptions within the meaning of section 302 (a). At the corporate level, however, a redemption reduces accumulated DISC income, to the extent of the dividend upon redemption. Where shares are again transferred by the first transferee, this treatment follows the stock in the hands of each transferee until actual distributions exhaust the amount of such gain.[207]

Generally, deemed distributions increase the basis of the stock of the shareholder treated as receiving such distributions. Generally, distributions treated as from previously taxed income reduce the basis of the shareholder's stock. If such distributions exceed the basis of his stock, they are treated by the shareholder as capital gain.[208]

FOREIGN TAX CREDIT ASPECTS

Section 502 of the Revenue Act of 1971,[209] amends Sections 901 and 904 of the Code, and section 503 of the Act,[210] amends sections 861 (a) (2) of the Code, usually so that dividends of a DISC are treated as from a foreign

204. *Id.* § 1.996-3 (b).
205. *Id.* § 1.996-3 (c).
206. *Id.* § 1.996-3 (d).
207. *Id.* § 1.996-4.
208. *Id.* § 1.996-5.
209. *Revenue Act of 1971, Pub. L. No.* 52-178, § 502, 85 Stat. 549.
210. *Id.* § 503, 85 Stat. 550.

corporation, and thus a passed-through foreign tax credit is allowed to corporate shareholders of a DISC. This treatment is limited to distributions of the DISC which are derived from QER, and would be subject to the usual limitations of section 902.[211]

Generally, then, if a DISC had earnings from an export transaction of 50, and this was the total of its earnings for the year, and if it paid foreign income taxes of 30 on such earnings (for example, because title to goods sold by the DISC passed in a foreign country, etc.) and if the only distributions from the DISC for the year were a single deemed distribution of one-half its taxable income (25, ½ of 50), under section 995 (b) (1) (B), the shareholder of the DISC would be entitled to a foreign tax credit of 15. Presumably, this would be computed as is the foreign tax credit under section 902 for any subsidiary corporation; that is, on a grossed-up basis, and with reference to the portion of the total earnings of the DISC which are so distributed. In the example, the DISC had total earnings of 50 and distributed one-half. The shareholder of the DISC would include the amount of the distribution, 25, plus the amount of the foreign tax paid on that distribution (one-half the total foreign tax of 30, or 15), so the amount included by the shareholder would be 40 (25 + 15). The tentative tax at forty eight percent on 40 would be 19.20, and the deemed paid foreign tax credit of 15 would be credited against this amount, for a total United States tax of 4.20. Presumably, the remainder of the foreign tax paid by the DISC would be allowed as a credit to its shareholders, in the later year when the earnings with respect to which such foreign tax was paid are distributed.

A pass-through of foreign tax is also allowed, for foreign tax credit purposes, for second and third tier corporations. In the usual case this will mean that foreign taxes paid by a FISC, the stock of which is owned by the DISC, will pass-through to the shareholders of the DISC, when distributions of the DISC are made to them. Since, under section 901 (d) and regulations 1.901-1, a DISC is treated as a foreign corporation for purposes of the foreign tax credit rules, and since, under regulations 1.902-4 (a), a DISC may not be treated as a less developed country corporation, and further, since under section 902, the gross-up requirement turns on the status of the first tier subsidiary (which presumably will be the DISC), even if the FISC is a less developed country corporation gross-up will be required— because the DISC cannot be an LDCC.

Generally, the effects of these foreign tax credit pass-through rules are to encourage full current distribution of as large a portion of the earnings of the DISC as is feasible, for the credit will not pass-through until distribution is made, and thus United States tax liability will remain unadjusted. Ownership of the stock of a DISC by individuals, as opposed to corporations,

211. I.R.C. § 861 (a) (2) (D): Interest from United States sources is not treated as QER for this purpose.

where the DISC will incur substantial foreign tax liability, or owns the stock of a FISC which will incur such liability, is also discouraged because the deemed paid foreign tax credit is available only to corporate shareholders. In an appropriate case, if the parties wish to distribute income from the corporate level to the individual shareholder level, without imposition of tax at the corporate level, more than one DISC would be advisable, for this would permit arrangement of the affairs so that foreign tax liability would be incurred by the DISC whose stock is owned by a corporate shareholder, and for the stock of the DISC which will not incur foreign tax liability to be owned by individuals.

In a case where foreign tax liability is substantial, it would appear that the foreign tax credit rules for DISCs would suggest a non-DISC subsidiary as the better choice. This would seem to follow because the inability to pass-through foreign taxes to the shareholder of the DISC until earnings are distributed would defeat the purpose of DISC in the first place. For example, if the foreign taxes paid by a DISC are forty percent of its income, failure to distribute all the earnings of the DISC currently, to its corporate shareholders, would amount to deferral of twenty percent of that income as a credit.[212] Full current distribution to take advantage of the credit, however, would simply take away the point of DISC.

SOME INCIDENTAL ASPECTS OF DISC

A. *Section 502*

Section 502 of the Revenue Act of 1971,[213] makes several conforming and incidental changes in various rules of the Code. These, and the regulations sections, amended to conform to such section of the Act, are noted below:

(1) 1.264-4. Dividends received deductions are not allowed for distributions from a DISC, unless they are from other earnings and profits.

(2) 1.301-1 (o). Cross referencing, in effect, to section 997, and providing that a distribution of property from a DISC to a corporate shareholder is treated as distributions to individual shareholders — the basis of the property, in the hands of the shareholder, is the fair market value. Money and obligations of the DISC are not so treated, and the distribution must be from accumulated DISC income, or previously taxed income of the DISC, to be so treated.

212. Generally, one-half the DISC's income would be deemed distributed under section 995 (b) (1) (B), one-half the foreign tax credit would be allowed as a credit, and, thus, one-half the foreign tax paid by the DISC would be recovered currently, as a reduction in United States tax liability. But, the remainder of the foreign tax paid would not serve to reduce United States tax liability, until the DISC distributed income, and, thus, the credit is deferred.

213. Revenue Act of 1971, Pub. L. No. 92-178, §§ 502, 85 Stat. 549.

(3) 1.901-1. A dividend from a DISC is treated as from a foreign corporation, for foreign tax credit purposes, if treated as foreign source under section 861 (a) (2) (D).

(4) 1.902-3 (a). Similar to (3) *supra*.

(5) 1.902-4 (a). A DISC or former DISC may not qualify as a less developed country corporation, under section 902.

(6) 1.922-1. A DISC may not be treated as a Western Hemisphere Trade Corporation. Further, a corporation that owns "directly or indirectly" any stock of a DISC may not be treated as a Western Hemisphere Trade Corporation.

(7) 1.931-1 (j). A Possessions Corporation may not be a DISC and may not own stock in a DISC.

(8) 1.1014-1 (b). Cross references to the special section 1014 rule for DISC stock, discussed in (9) *infra*.

(9) 1.1014-9. This is a new provision. If there were no special rule, stock in a DISC held by a decedent would have a basis, in the hands of the heir, equal to its fair market value on the date of death (or estate tax valuation date), and the mechanism of section 995 (c) would not serve its purpose— because there would be no gain upon an immediate sale of the DISC stock by the heir, even though some portion of the value of the stock was attributable to accumulated DISC income. To prevent this result, new section 1014 (d) and 1.1014-9 reduce the basis of such stock by the amount which would have been treated as a distribution to the decedent under section 995 (c), had he sold the stock for the amount of its estate tax valuation. Distributions which would have reduced the basis of the stock in the hands of the decedent also reduce its basis in the hands of the estate, if the alternative valuation date is elected.

B. Section 503

Section 503 of the Revenue Act of 1971,[214] generally amends section 861 (a) (2) (D) to authorize the Treasury to issue regulations treating dividends from a DISC as non-United States source, where they are attributable to QER.

C. Section 504

Section 504 of the Revenue Act of 1971,[215] relates to returns of DISCs and penalties for failure to file such returns.

D. Section 505

Section 505 of the Revenue Act of 1971,[216] amends section 971 (a) of the Code to prevent any corporations from qualifying as Export Trade Corpora-

214. *Id.* § 503, 85 Stat. 550.
215. *Id.*
216. *Id.* § 505, 85 Stat. 551.

tions, after November 1, 1971, and permits an existing Export Trade Corporation to transfer its assets to a DISC, under certain circumstances.

CONCLUSION: PLANNING AND POLICY

This section of the paper attempts to set forth some of the more important considerations in choosing whether to elect DISC treatment and how to carry on the activities of the DISC to maximum tax advantage. I also examine briefly the policy aspects of the DISC provisions. The two former categories are treated selectively; that is, they discuss only what appear to be the most relevant and important matters, and omit consideration of detailed aspects of many of the provisions involved.

Generally, citations to the relevant provisions of the regulations are not made, and it is assumed that the reader has read the technical discussion which precedes this portion of the paper.

Is DISC the Best Alternative?

The principal alternatives to DISC, as forms for export, are (1) direct export by the parent corporation of the DISC, (2) operation of a foreign branch of such corporation, (3) creation of a foreign incorporated subsidiary of such corporation, (4) creation of a non-DISC United States subsidiary corporation, and (5) creation of a United States subsidiary corporation which qualifies as a Western Hemisphere Trade Corporation (hereinafter WHTC). Alternatives (1) and (2) may be disregarded, since they would result in current taxation of export income at regular United States income tax rates. These alternatives could be attractive, if export sales were not profitable, because they would permit full current use of losses. However, the same result could be achieved with a DISC, simply by not channeling loss sales through the DISC.

Creation of a foreign subsidiary, as a vehicle for export transactions, would be of advantage if the Controlled Foreign Corporations provisions could be avoided.[217] But, perhaps the easiest way (in this context) in which this could have been done, by qualification as an Export Corporation, was eliminated by section 505 of the Revenue Act of 1971.[218] Even assuming it is possible to avoid the Controlled Foreign Corporation provisions, and assuming the income of such subsidiary is taxed at a lower rate by the country in which it operates than it would have been had it been distributed to the United States shareholder, transactions with such a subsidiary would be subject to the arm's-length standards of section 482. This would involve two considerable difficulties: it is unlikely the Service would accept as favorable pricing as is permitted under DISC,[219] and it is difficult, in many

217. Generally, sections 951-964 of the Code.

218. Revenue Act of 1971, Pub. L. No. 52-178, § 505, 85 Stat. 551. (an extra-Code provision).

219. *See* section 994.

cases, to determine in advance of audit what pricing will survive the Commissioner's scrutiny, under section 482.

Generally, the effective rate of tax on profits of sales made through a DISC will be about thirty six percent, if the DISC's shareholder is a corporation. This is so because, generally, the combined taxable income method of pricing, under section 994, will put the greatest allowable income in the DISC. One-half of the one-half put in the DISC will be deemed distributed to the shareholder, under section 995 (b) (1) (D), in each year. Thus, even if the same amount of income could be put in the foreign subsidiary under section 482, as can be put in the DISC under section 994, the effective rate of tax in the country where the subsidiary operates would have to be less than thirty six percent, for deferral to be of equal or greater value than DISC treatment. If one assumes a lesser proportionate part of the income from export could be put in the foreign subsidiary, under section 482, the effective foreign tax rate would have to decrease. For example, if section 994 would permit 100 of income from export to be put in a DISC, but section 482 would only permit 90 of income to be put in a foreign subsidiary (*i.e.*, if section 482 required the foreign subsidiary to pay the United States parent corporation a price ten percent higher than a DISC would be required to pay under section 994), the effective rate of tax in the country where the foreign subsidiary operated would have to be about twenty one percent, for the same overall tax in the two cases (*i.e.*, if the tax rate is thirty six percent, and 100, the DISC's share, is one-half the total export income, then total export income is 200, and target total tax is seventy two (thirty six percent of 200); if a foreign subsidiary's share of 200 income is 90, the parent's share is 110, and the tax on 110, at forty eight percent, is 52.80; the tax remaining after 52.80, on parent's share, is 19.20, so the effective rate of tax in the foreign country is 19.20/90, or 21.33% (this way of computing is discussed more fully in the treatment of WHTC). Additionally, it is possible that the tax authorities of the foreign country would not accept the arm's-length price, under section 482, asserted by the Commissioner; requiring a resort to the rather unsatisfactory, competent authority procedure.

On the whole, it would seem that the availability of generous and predictable prices under section 994, in the usual case, would make DISC more attractive than a foreign subsidiary, even if controlled foreign corporation status could be avoided.

There would seem little advantage to a domestic subsidiary. Export income would be taxed to such corporation, in full, currently. A dividends received deduction, under section 243, would be allowed for distributions from such subsidiary, but this would not reduce the effective rate of tax on its income. There would be no advantage to shifting income into such subsidiary, since the subsidiary would be taxed at the same rates as its parent corporation.

A Western Hemisphere Trade Corporation subsidiary is an attractive alternative to a DISC, since its income is taxed at an apparent effective rate of thirty four percent, as compared to thirty six percent, generally, for a DISC.[220] The real effective rate on a WHTC, however, if the same assumptions are made as for DISC, is forty one percent. This follows, because it was assumed for DISC that one-half the profit from an export transaction was put in the DISC, under the combined taxable income method of section 994, and one-half in the DISC's parent corporation. If this assumption is also made for a WHTC (*i.e.*, that section 482 would permit the same price as the combined taxable income method, under section 994, and if the effective rate is stated in the same way as it is stated for DISC, that is, tax paid on total export profits as a percentage of such profits), one-half of export income would be taxed to the WHTC, at thirty four percent, and the other half to its parents, at forty eight percent (so, if total export income is 100, the tax (thirty four percent of 50) + (forty eight percent of 50) = 41; 41/100 = forty one percent). To put it another way, a lot of the literature is completely misleading when it refers to an effective rate of thirty four percent, on a WHTC. Determined in the same way, the effective rate on the income of a DISC is twenty four percent. The source of the error is the failure to note the different base on which the effective rate of each is determined.[221]

Thus, the section 482 price, for a transaction between a WHTC and its parent, would have to be more favorable to the WHTC (*i.e.*, the WHTC would have to be permitted to pay a lower price to its parent) than the section 994 price to the DISC, in order for the effective rates of tax to be the same. For example, if section 994 would permit a price to the DISC which would give it 100 of export income, and that was one-half of the total export income from the transaction, section 482 would have to permit a price which would give the WHTC 110.42, of the total 200 export income, for the effective rates to be the same (generally because 10.42 of income, taxed at forty eight percent to the parent, would have to be shifted to income of the WHTC and, thus, taxed at thirty four percent in order for total tax to be thirty six percent). It seems unlikely that section 482 would permit a price that much more favorable to a WHTC, than section 994 would permit to a DISC.

It may be argued that DISC deferral is temporary, while the WHTC tax rate is permanent. Superficially this is true, but in practice it is not, since a WHTC, like a DISC, is likely to be merely a subsidiary of a larger parent corporation. In order to make use of the profits of a WHTC subsidiary, it is

220. Surrey, *Current Issues in the Taxation of Corporate Foreign Investment*, 56 COL. L. REV. 815 (1956) [hereinafter cited as Surrey].

221. *See, e.g.*, Bedell, *DISC, A Panel Discussion*, 26 TAX LAW, 537, 544 (1973), (corrected immediately after by Patrick. *Id.* at 545. Curiously, the misimpression lingers).

necessary to distribute its earnings, and thus subject them to taxation.[222] In the case of a DISC, earnings can be distributed as producer's loans, or as actual distributions from previously taxed income.

On the whole, then, it would appear that DISC is more attractive than its two closest competitors, a foreign subsidiary and a WHTC, mainly because of the section 994 pricing rules, which ordinarily will permit more export income to be put in the DISC than section 482 would permit in the foreign subsidiary or WHTC, and (perhaps of equal importance in a business context) will permit precise predictions of the tax consequences of transactions with the DISC (it was the author's experience that as much pressure was put on Treasury by the business community to make section 482 predictable, as to make it more favorable).

B. How Should DISC Be Used?

The key to benefits from a DISC is the section 994 pricing rules, for these, generally, are the reasons why DISC is more attractive than alternative forms of export operation. It is the income allowed to be put in the DISC, under those rules, which makes available income to be "loaned" back to the parent corporation (as producer's loans) without an end to the deferral, income to be used to purchase trade receivables of the parent, and, generally, which makes the whole machine go, by shifting the necessary income into the DISC, from related taxpayers.

Handling the pricing rules is relatively simple, for they are highly mechanical. Generally, there are two crucial choices to be made: is marginal costing advantageous, and, if not, can expenses easily be shifted to the DISC, so they will qualify as Export Promotion Expenses (hereinafter, EPE)?

The availability and benefit of marginal costing depends on the percentage of profit earned on export sales of the product involved, including those by the DISC, as compared to the percentage for domestic sales of the product. This is so because it may safely be assumed that marginal costs, as defined in the regulations, will be far less than full costs, determined under section 471. Thus, the relevant factor is the "overall profit percentage limitation" of the regulations, for this will, apparently, usually result in a higher price to be paid by the DISC, under the marginal costing rules, than a price determined only with reference to the costs themselves. The more the profit percentage on domestic sales exceeds the percentage on foreign sales, the lower the price the DISC must pay its parent, and, thus, the greater the share of income that is put in the DISC.

If marginal costing is not advantageous, because export sales are as profitable, or nearly so, as domestic sales, the name of the game is primarily EPE, and, secondarily, grouping. As was seen above, every dollar of

222. Surrey, *supra* note 220.

expense shifted to the DISC defers five cents of income and, thus, reduces the effective current tax rate by 2.4 cents (because income, which was subject to tax at forty eight percent, is no longer subject to current taxation in full, only the amount, generally one-half, deemed distributed is taxed currently; this assumes that all expenses shifted to the DISC will be EPE). For example, if total export income was 100, from a transaction, and it was split equally between the DISC and its parent, by use of the combined taxable income method, and if expenses related to the transaction which could be shifted and would qualify as EPE were 20, shifting those expenses to the DISC would reduce the current effective tax rate from thirty six percent to a current effective rate of 35.52% (*i.e.*, if DISC has no EPE and 100 split evenly, the parent has income of 50, from the price it is paid by the DISC, and receives a deemed distribution, under section 995 (b) (1) (D), of 25 (one-half the DISC's income, 50). So, 75, (50 + 25) is taxed currently at the parent's rate, forty eight percent, or forty eight percent of (50 + 25) = 36; if DISC has EPE of 20, the parent's share is reduced by 2, from the price (because DISC's share increased by ten percent of the 20 EPE, or 2), and increased by 1, from the deemed distribution (one-half the increase in the DISC's share), so 74 is now taxed currently at forty eight percent (forty eight percent of (48 + 26) = 35.52)). If total export income was $1,000,000, this would represent an increase in after-tax income of $14,800, or an increase of about 4.17% which could be quite attractive in terms of increase in return on equity.

Aside from shifting expenses into the DISC, perhaps the most attractive possibility, under the pricing rules, is to manipulate groupings of products into product lines. Here there are two parlays—grouping so that sales at a loss will not be made through the DISC, and grouping sales through the DISC to take advantage of the pricing methods. Obviously, there is an advantage to keeping sales at a loss out of the DISC, since loss sales would reduce favorably treated income of the DISC, and the reduction in the usual deemed distribution, under section 995 (b) (1) (D), will be only one-half the amount of the loss.

Manipulating groupings of profitable sales through the DISC is somewhat complex, for each pricing method can be advantageous under some circumstances; so the choice of groupings requires a choice of pricing method as well. Generally, the starting place in the recipe is marginal costing. Here, the advantage depends on the overall profit percentage, but that, in turn, can be determined on the basis of a grouping different from that which is used for actual computation of the price, under the marginal costing rules. Thus, for example, if three products are involved and there are two possible groupings, one which would include two of the THREE products and a fourth product, and another grouping which would include all these products and no other, the profit percentage for each grouping must be determined. Assuming that one grouping produces a better profit percentage than the other (that is, the domestic rate of profit is much higher than the export rate of profit, on one grouping as compared to the other), a separate determination of the most advantageous grouping for the actual price computation must be made. For example, it may be that the reason one grouping produces a far better (higher) profit percentage limitation, than the other grouping, is that labor costs for exported units of the product (not included in the first grouping) are much greater than labor costs for domestically sold units. Since labor is a direct cost, this might (though it is unlikely) increase marginal costs, under that grouping, to the point where the actual price may not come up to the amount allowed by the profit percentage limitation. The choice would then be clear— choose the grouping which excludes the high-costs product, for both determination of the profit percentage and computation of the actual price. In other cases, it may be that different groupings, for each use, may be more beneficial.

In considering the groupings under marginal costing, the selection of the grouping actually used to compute prices may be greatly influenced by the effect on groupings used under other methods. For example, a product may overlap, in a sense, two groupings; that is, it may be included in one possible grouping of products, for which marginal costing may be beneficial, and it may also be includible in another grouping, which would not benefit from pricing by the marginal costing rules. If the profit percentage limitation is high enough, it may be of advantage to choose the grouping, for computation of actual prices under marginal costing, which includes that product; simply as a way of taking the product out of the other grouping, used for purposes of the non-marginal costing method. To put it another way, it may be worthwhile to take less in one grouping, if, as a result, the DISC can get more in another.

It is possible that the real marginal costing rules will not be as beneficial as the ersatz marginal costing, of the special no-loss rule, for the four percent method. For example, where the profit percentage limitation is high, but the actual price which can be realized from export is small, in relation to direct costs (*e.g.*, where pricing from a business, not tax, point of view is based on marginal costs), four percent of the export price may be more than one-half the profit from the export transaction. In such a case, the special no-loss rule for the four percent method would give the DISC more income from the transaction and should be chosen.

Even if marginal costing, real or ersatz, is not feasible (because export profits are as large as domestic profits, as a percentage of sales), grouping can be used to advantage under the regular pricing rules. The approach here is simpler, for each of the methods has its definite advantages. The four percent method is useful where profit on export sales is low, because it gives the DISC a flat percentage of sales as profit (ignoring losses). The combined taxable income method is the best choice when profit from exports is large (generally where greater than eight percent of sales), because the DISC's share increases as export profits increase. EPE should have little effect on this choice, because in each method they are simply added to the DISC's share. Thus, to maximize benefits of DISC, low profit products should be grouped together, with the four percent method chosen, and high profit products should be grouped together, with the combined taxable income method chosen. The point is simple—including low profit products in a combined taxable income group reduces the average percentage of profit for that group, and, thus, reduces the DISC's share. Including high profit products in a four percent group wastes the increased share the DISC could have received, under the combined taxable income method.

As noted above, pricing (in conjunction with the deemed distribution rules of section 995) can be used to shift income within a controlled group, or from the corporate level to the shareholders, without a tax at the corporate level.

C. *Characteristics of the DISC*

The general rules of DISC are quite liberal in not requiring the DISC to have substance, or to do much of anything to earn its income. On a commission basis, a DISC can merely be an incorporated file drawer, with no employees, assets, etc. In effect, a DISC can really be just a tax return for some of the activities of its related persons.

Perhaps the only significant reasons to put meat on the DISC's bones are two: to avoid the problem of nonqualified years, and to realize the advantages of EPE. A great question mark in DISC is the treatment of a DISC with no substance, in nonqualified years.

Clearly the regulations, and the legislative history, recognize that a qualified DISC, treated as a corporation because of the DISC provisions, could be attacked as not being an entity separate from its shareholders, but for the DISC provisions. At that point, however, clarity ends. Would a no-substance DISC be treated as a separate entity in nonqualified years? Would the items of such a former DISC be treated as distributed, when its separate entity status fails? These and questions along the same lines are unanswered, and the only easy way to answer them is eliminating them, by putting substance in the DISC.

It should be noted that the legislative history, and regulations, may be dragging a red herring across a tax counselor's path. As noted above, in the body of this article, the real issue here seems to be not only separate entity characterization, but attribution of income as well (and perhaps far more importantly). Here, even substance in the DISC would not be the answer—only by performing real functions in export transactions would a former DISC seem safe from section 482 allocations.

More concrete are the EPE aspects of substance. Expenses must be "incurred" by the DISC, under the regulations, to qualify as EPE. To the extent (not very great under the regulations) this requires the DISC to actually do something, it places a significant premium on substance. When combined with avoidance of the problem of treatment as a separate entity, it would seem quite advisable to put as much substance in the DISC as is reasonable.

Apparently, the draftsmen of DISC had in mind that the DISC would use its tax-deferred income to lend funds to its parent corporation. Producer's loans, the deemed distributions for interest paid on them, and foreign investment limitations applicable to them all, square with this reading. There is little reason, however, to play this part of the game according to plan—purchase of the trade receivables of the parent corporation has the advantages of producer's loans, and more. It does not have their disadvantages.

Generally, interest paid to the DISC on producer's loans is deemed distributed in full, to the DISC's shareholders, and since interest is deductible by the payor, if such a loan is to the DISC's parent corporation, the deduction and deemed distribution will wash. Complicated computations are required to determine if the members of the DISC's controlled group have invested abroad—if so, there are deemed distributions, generally, to prevent use of the producer's loans to finance foreign investment. Also, in order to be entitled to producer's loans, the borrower must be continuously increasing its investment in plant and equipment. At the very least, producer's loans impose substantial accounting and record-keeping costs, and are a pain in the neck.

Purchase of the parent corporation's trade receivables, arising from export sales through the DISC, is a less troublesome way to get more benefits than producer's loans. Such purchases of trade receivables do not result in deemed distributions of the payments of interest, and only one-half of such interest is deemed distributed each year (as part of the regular section 995 (b) (1) (D) deemed distribution, of one-half the DISC's income). Instead of a wash, as with producer's loans, income (one-half the interest payments) is shifted from the DISC's parent, to the DISC. There are no foreign investment limitations on the use of the funds the DISC pays its parent for such receivables, and the parent need not increase its investments in domestic plant and equipment to qualify. Since the trade receivables are for the price paid by the foreign purchaser, and here we are discussing what the DISC should do with its share of the profit from the sale, which presumably will be a fraction of the price, there should be a plentiful supply of trade receivables for the DISC to buy.

D. *What Will the Average DISC Look Like?*

The average DISC will probably be a purely paper corporation, operating as a commission agent of a single exporting corporation, under an agreement which allows the DISC (as its commission on export sales) the maximum amount permitted under the section 994 pricing rules. Its capital, to the extent it has any, will be in the form of minimal stock ($2,500) and the remainder "debt". Most of the expenses it incurs will merely be paper entries, insertion of the DISC in contracts for the performance of services in connection with export transactions with third parties, so that the DISC will be treated as having "incurred" such expenses under the EPE rules, and perhaps a few expenses really incurred by the DISC, to secure further EPE.

The income of the DISC, from its commissions, will also largely be a paper entry; merely a transfer from an account labelled "DISC Commissions", to an account labelled "Trade Receivables Purchased by DISC". To the extent of the regular deemed distributions of one-half the DISC's income, under section 995 (b) (1) (D), the DISC will make actual distributions— again mere paper entries in the accounts of the DISC and parent corporation, since these will not be taxed a second time, when distributed. Thus, perhaps the only assets credited to the DISC will be made trade receivables of foreign purchasers and the DISC's minimal capital.

The picture that emerges, then, is one of almost total artificiality, a paper world of accounts based upon an unwilling suspension of disbelief by the Service.

E. Policy Aspects of DISC

The purpose for the existence of DISC is the encouragement of exports, through reduction of the effective rate of tax on income from them. Thus, the most basic question of policy is whether one supports use of the tax system for purposes other than raising revenues.

The advantages and disadvantages of such use are many, and need not be rehearsed here.[223] Generally, the question would seem to resolve itself into two approaches: what are the effects of the characteristics of the tax system on the subsidization, and what are the effects of the tax provisions, which are the vehicle for the subsidization, on the rest of the tax system. Having these clearly in mind, one can compare the use of the tax system to alternative vehicles for subsidy.

1. Subsidization and the Tax System

In examining the effects of the characteristics of the tax system on the subsidy (to put it in plain English, who gets how much because the tax system is used, as compared to who would get how much under a direct subsidy, or other alternative), one must decide whether or not to assume that people eligible for benefits will make the maximum use of them. For example, it is reasonably clear that the draftsmen of the DISC provisions thought in terms of producer's loans as the vehicle for distribution of the DISC's tax deferred profits to its shareholders, and they designed elaborate limitations on such loans, and on their use. In fact, it is just as possible for the DISC to purchase the trade receivables of its parent corporation, thus

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223. *See* SURREY, PATHWAYS TO TAX REFORM (1973).

bypassing the limitations and restrictions on producer's loans. Should one assume that the person using DISC will be aware of all these ins and outs? Probably so, and, thus, one cannot take statements in the legislative history at face value and as one's starting point, for these are based on the assumption, apparently, that the overall scheme will resemble the reality of DISC. Thus, assertions that the tax deferred profits of a DISC may not be invested overseas are not acceptable, and consideration of the effects of the tax system on the subsidy must be based upon the actual pattern of the DISC rules, not the pattern intended by the draftsmen.

Use of the tax system as a vehicle for subsidizing exports has an immediate consequence of great complexity. This is so, basically, because such a vehicle is necessarily built backwards. Instead of deciding who will get the subsidy, and simply giving it to them, one must determine how the desired beneficiaries are taxed, and then selectively undo the tax rules, to the extent that the tax reduction will provide the desired subsidy. Necessarily, this will mean that the subsidy is unevenly distributed among potential beneficiaries; for the exact amount of the subsidy each receives, and the conditions which are attached to it, will depend on factors extraneous to the simple consideration, who should be benefited. In the case of DISC, the use of the tax system, and its attendant complexity, immediately limits the benefits of the subsidy to those who are exporting enough, or can export enough, to make the costs of accounting and legal fees a small portion of the tax benefits derived. Thus, a small business, say one with export sales less than several hundred thousand dollars, would probably not benefit from DISC, because the accounting and legal fees would wipe out the tax savings.

Other aspects of the tax system which immediately effect the distribution of the subsidy are the nature of the business of the party, and the relative profitability of his domestic and export sales. If the business of the taxpayer is complex, and involves the sale of many products, it can benefit considerably from the relatively loose grouping rules for products, under the pricing rules. Furthermore, it can benefit from the ability to incur substantial costs, for setting up new subsidiaries and otherwise altering the corporate structure, to get maximum benefit from the income shifting possibilities, and the capital gain possibilities, upon termination of the existence of the DISC. Thus, generally, the larger the enterprise involved, the greater are the likely benefits available under DISC. The rather severe limitations on favorable treatment of services also means that sellers and lessors of property are favored over those who perform services. The relative profitability of domestic, as compared to foreign, sales has a considerable effect on the attractiveness of DISC; for a large difference will make available the considerable benefits of marginal costing.

The picture of the subsidy that emerges, then, because the tax system is the vehicle chosen for its implementation, is one of subsidy to large corporate enterprises which have substantial and profitable domestic markets for their products. DISC, in short, is a way of subsidizing the export activities of big business.

2. DISC and the Tax System

What is the effect of the DISC provisions on the rest of the tax system? The most obvious effect is a substantial increase in the complexity of the foreign tax provisions. DISC adds several new provisions to the Code, amends several existing sections, and effectively eliminates others. More importantly, DISC enables taxpayers who are eligible for its benefits to bypass several sets of tax rules, which have evolved over the years, to prevent certain abuses. Perhaps the most glaring example is the pricing provisions of section 482. In the main, the present role of section 482 is to prevent taxpayers from shifting income from United States entities to foreign entities, through manipulation of pricing, so as to take advantage of a lower foreign tax rate. DISC, in effect, brings that lower foreign tax rate back to to the United States and abandons the arm's-length approach of section 482. In a way, this is like curing the problem of section 482, and non-arm's length dealing, by simply giving up the fight. By inserting a DISC between the domestic parent and its foreign subsidiary, the taxpayer can accomplish the same as if he were permitted to price his sales to the foreign subsidiary, to shift income into it at the lower effective foreign rate. To top it off, the operations of the foreign subsidiary can even be funded from the tax deferred profits of the DISC, through purchase of its stock by the DISC, and distributions from the foreign subsidiary will be sheltered from full current taxation in the United States, under the DISC provisions.

Oversights in the design of DISC may be expected to put pressure on other parts of the Code. The primary victim here would seem to be the slowly evolved doctrine of separate entity status.

It seems unlikely, in view of the clear recognition in the DISC provisions that a corporation may qualify as a DISC for some years and not for others, that a rule denying separate entity status to a former DISC, in nonqualified years, would be feasible. Rules for the gradual deemed distribution of the tax-deferred profits of a former DISC, over the several years of disqualification, following a year of qualification, would make no sense without very complex modification, if the former DISC were not treated as an entity separate from its shareholders. To treat such a corporation as a separate entity, however, when it has no substance, would seem to seriously undermine the possibility of attacking other paper-thin subsidiaries as not being separate entities. In effect, it would seem possible that separate entity treatment for a former DISC will wash back into the treatment of corporations which have never been DISCs.

3. Alternative Subsidies

How would alternative mechanisms for the subsidy be better? In the first place, it would be possible, through a direct subsidy, to benefit the exports of small as well as large business, because the complexity of the subsidy mechanism could be considerably lessened, as compared to subsidy through the tax system. Thus, more potential beneficiaries would understand how they were to get benefits, and could afford the legal and accounting fees to obtain them. Secondly, the amount of the subsidy would not have to depend on the profitability of export transactions, either *per se* or relatively, to domestic profitability.

Generally, the greater the profitability the greater the benefits of DISC. This is so because the availability of the combined taxable income method means that an increasing share of export profit can be put in the DISC, as profitability increases. Thus, for example, if profitability is ten percent, five percent, or one-half the profit, may be put in the DISC and sheltered. If profit is twenty percent of selling price, ten percent, or one-half, can be put in the DISC under the combined taxable income method. A direct subsidy could be arranged to operate in just the opposite way, the lower the profitability, the greater the subsidy. This would seem far more reasonable, for it would subsidize the people who need the most encouragement to export; those who do not make a great deal of money from doing so.

In a limited way, marginal costing under the DISC pricing rules is designed to increase the benefits of DISC as export profits decline, but the mechanism operates in terms of the relationship between export profitability and domestic sales profitability. Thus, not all taxpayers whose export sales have a low profitability are benefitted, but only those who also have large and profitable domestic sales. Under a direct subsidy system, it would be possible to benefit an exporter, whether or not he had large and profitable domestic sales, if he simply had unprofitable export transactions.

Overall, perhaps most significant, a subsidy would be simple, and could be aimed very precisely. It is true, perhaps, that exports of agricultural commodities benefit the United States' balance of trade and, thus, its balance of payments. It is also true, however, that such exports have created domestic chaos in the economy and have imposed a large (and perhaps not fully appreciated) burden on consumers, especially at the lower end of the income scale. The cumbersome way of dealing with such situations under DISC is a denial of the benefits to such exports, by defining them out of export property status, and thus denying, to a large extent, the possibility that a DISC will export such commodities. A subsidy, rather than having to take away what has been granted in this indirect fashion, could simply be withheld.

These objections are not to say that the same results could not be achieved under the tax system as could be achieved under a subsidy system. They really point to the conclusion that simplicity, and thus administrability, is far greater with a direct, than with an indirect, means of achieving the objective.

F. Disc in the International Economy

Does DISC encourage exports? Since DISC is merely one of many factors which enter into a consideration by a businessman of the possibility of export, it will probably never be possible to pinpoint exactly the role of DISC, in the international economy. It would seem unreasonable to dismiss DISC as a factor altogether, since it very clearly has the potential of increasing aftertax profit on exports, and so could make profitable export transactions, which would not be without its benefits. To a large enterprise, with an already substantial rate of profit on export sales, DISC could be so attractive that exports would be very attractive indeed. The point, however, seems to be that one can never know just what effect DISC has, especially since other factors, such as the devaluation of the dollar, are present at the same time.

G. A Better DISC

If there's going to be a DISC, how could it be better? The benefits of simplicity would be considerable. Small exporters would be able to afford the benefits, there would be some hope that the Service would be able to administer its provisions, and some possibilities for abuse would be eliminated.

Either the availability of trade receivables, as QEA, should be eliminated, or the producer's loans foreign investment limitation should be applied to them. As things stand now, the principal limitation on investment of tax deferred income of the DISC abroad is the system of deemed distributions, for foreign investment, attributable to producer's loans. These limitations are more important than they seem, for some other provisions of DISC appear to depend on them. For example, the availability of the stock of a FISC, as QEA of a DISC, seems to be premised on the existence of producer's loans to members of the DISC's controlled group, to control the amount of investment which may be made in such foreign corporations. If, however, these limitations may be bypassed by the simple expedient of buying trade receivables, instead of making producer's loans, these other provisions do not operate as anticipated.

The provisions relating to Export Promotion Expenses should be eliminated. Presumably, the premium for incurrence of export promotion expenses by the DISC is based on the belief that substance in the DISC is a good thing. It is hard to see why this is so, since an expense which would so qualify would presumably be incurred by the parent corporation anyway, if it is necessary, and the premium for EPE is not great enough to cause taxpayers to incur needless expenses. Perhaps the only function of such a premium is to encourage use of United States transportation firms, but it seems plain silly to do so at such a high price. If this is the real goal of EPE, a simple rule that prohibited shipment by a non-United States carrier would do the trick.