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Domestic International Sales Corporations: In Defense of Producer's Loans

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DOMESTIC INTERNATIONAL SALES CORPORATIONS: IN DEFENSE OF PRODUCER'S LOANS

To help alleviate America's then worsening balance of payments position, Congress, in the Revenue Act of 1971, established Domestic International Sales Corporations (DISCs) to give United States businesses an incentive to increase their exports.[1] DISCs were designed to achieve this objective by enhancing the competitive position of domestic producers in the international marketplace through a program of income tax deferral under which a DISC could defer income tax on as much as 50 percent of its profits, provided the DISC's assets and revenues were substantially related to export activity.[2] In devising this

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1. Pub. L. 92-178, Title V, 92d Cong., 1st Sess., 85 Stat. 535 (Dec. 10, 1971); INT. REV. CODE OF 1954, §§ 991-997 [hereinafter cited as I.R.C.].

In 1971, the United States suffered approximately a $2.8 billion deficit in its merchandise trade balance, after having experienced an average surplus during the previous four years of roughly $1.8 billion. In 1972, the deficit increased to approximately $6.9 billion, and it was not until 1973, with a surplus of about $0.7 billion, that the decline halted, and the trend reversed. This positive merchandise trade balance continued into the first quarter of 1974, but a large deficit in the second quarter—due to a sharp jump in oil import prices and the generally higher prices of most imported goods—caused a net deficit for the first half of 1974 of $1.4 billion. *See* U.S. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 764 (1972); CCH BALANCE OF PAYMENTS REP. ¶ 9146 (1973) and ¶¶ 9178, 9182, 9185 (1974).

It is not clear exactly how much DISCs have contributed to restoring the balance-of-payments, but at the time the DISC proposal was enacted, the Treasury Department estimated that it would result in an increase in annual export sales of $1.5 billion. *See Hearings on the Tax Proposals Contained in the President's New Economic Policy Before the House Comm. on Ways and Means,* 92d Cong., 1st Sess. 16 (1971) [hereinafter cited as *1971 House Hearings*]. A favorable contribution is also indicated by the first annual report from the Treasury Department to Congress entitled "The Operation and Effect of the Domestic International Sales Corporation Legislation," covering the year 1972. *See* BNA DAILY TAX REP., April 15, 1974, J-1. The report tentatively compared the export growth rates of DISC firms with the export growth rates of non-DISC firms for the years 1971 and 1972. It showed that DISC exports grew by about 29 percent during the two-year period as against overall national export growth of about 12 percent. The comparison was "tentative" because of the scarcity of data and because of the difficulty of segregating the effect of the DISC legislation on 1972 exports from that of other events (such as devaluation and price controls), but the report concluded that the figures "suggest that DISC had a positive impact on exports." *Id.* The report also demonstrated the significance of DISCs, showing that about $16 billion of the total $49 billion of 1972 merchandise exports were handled by DISCs, and that over five thousand American corporations, by February, 1974, had elected DISC treatment. *Id.* at J-2, J-9.

2. The DISC legislation was by no means the first legislative effort to encourage exports or to improve the United States balance-of-payments position. In past years, Congress instituted the Interest Equalization Tax, the Foreign Investors Tax Act of 1966, and the Foreign Direct Investment Program. *See generally* Lancaster, *Taxes and the Balance*

scheme of tax deferral, Congress was guided by several considerations. First, it noted that manufacturers which export their products solely through domestic divisions are at a disadvantage compared to multinational firms which produce and sell abroad through foreign subsidiaries because foreign earnings of domestic producers are taxed currently at the full corporate rate of 48 percent, beyond the first $25,000 of income, while multinational producers can generally postpone American tax on foreign earnings until repatriated to the United States.[3] Second, Congress observed that other nations encourage the

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of Payments, 23 ARK. L. REV. 378 (1969). Other previous efforts through the tax system have been somewhat analogous to DISCs. For example, Western Hemisphere Trade Corporations are domestic corporations that derive 95 percent of their gross income from sources outside of the United States, but within the Western Hemisphere, and are allowed a special deduction which effectively lowers their tax rate to 34 percent. I.R.C. §§ 921, 922. Export Trade Corporations (ETCs) are American-controlled foreign subsidiaries whose sales income is not taxed currently, provided they derive 75 percent or more of gross receipts from the sale of property produced in the United States, and provided deferred income does not exceed the lesser of either 150 percent of export promotion expenses of the ETCs or 10 percent of gross receipts for the year. I.R.C. §§ 970-972. *See* B. BITTKER & L. EBB, UNITED STATES TAXATION OF FOREIGN INCOME AND FOREIGN PERSONS 346-73 (2d ed. 1968).

3. S. REP. No. 437, 92d Cong., 1st Sess. 90 (1971) [herinafter cited as SENATE COMM. REP.]. In regard to the DISC provisions of the Revenue Act of 1971, the Senate Finance Committee agreed with the House as follows:

> [I]t is important to provide tax incentives for U.S. firms to increase their exports. This is important not only because of its stimulative effect but also to remove a present disadvantage of U.S. companies engaged in export activities through domestic corporations. Presently, they are treated less favorably than those which manufacture abroad through the use of foreign subsidiary corporations. United States corporations engaging in export activities are taxed currently on their foreign earnings at the full U.S. corporate income tax rate regardless of whether these earnings are kept abroad or repatriated. In contrast, U.S. corporations which produce and sell abroad through foreign subsidiaries generally can postpone payment of U.S. tax on these earnings so long as they are kept abroad.

Normally, a foreign corporation, whether or not American-controlled, is not subject to United States tax on its foreign-source income, and its American owners, whether individuals or corporations, are not taxed on these earnings until they receive dividends from the foreign corporation. Congress, however, has enacted special provisions to require certain income of a controlled foreign corporation, designated "subpart F income," to be included in the gross income of United States shareholders in the year the income is earned abroad, even though it is not distributed. In general, these earnings include income derived from the insurance of United States risks, passive income of foreign personal holding companies, income derived from the sale or purchase of personal property for a related business entity (e.g., a domestic manufacturing parent), and income from the performance of services on behalf of the related business. I.R.C. §§ 951-964. American-controlled foreign corporations which manufacture or process goods do not fall within this subpart F exception. *See* B. BITTKER & L. EBB, *supra* note 2, at 338-48.

While foreign manufacturing subsidiaries may generally defer American taxes until the income flows into the United States, the price of this deferral is payment of foreign income taxes, which may be a substantial burden. The Treasury Department, for example, estimated that the effective foreign tax rate on all foreign subsidiary operations of American businesses was about 38.6 percent in 1964. *See 1971 House Hearings* 1062.

export trade of their domestic producers by refunds of indirect taxes and by certain features of their income tax laws.[4] Finally, it was suggested to Congress that tax deferral was preferrable to outright tax reduction for United States producers selling abroad, in order to comply at least nominally with Article XVI of the General Agreement on Tariffs and Trade which bars export subsidies.[5]

One of the primary uses envisioned by Congress for a DISC's tax-deferred earnings is the so-called "producer's loan," whereby a DISC is able to lend this income to United States manufacturers and producers.[6] A producer's loan is not taxable to the borrower, whereas a

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The effective tax rate on DISC earnings (taxed to its owners) is at least 24 percent, and probably more, because of the deemed and qualifying distributions of DISC income discussed in notes 15-18 *infra* and accompanying text. Thus, the tax rates applied to controlled foreign subsidiaries and to distributed DISC income are likely to be closely comparable.

There has lately been a great deal of controversy over continued preferential tax treatment of foreign earnings. For example, one of the proposed features of the recent Burke-Hartke Foreign Trade and Investment Bill—a legislative attempt at discouraging American business investment abroad—is full taxation of all profits of controlled foreign subsidiaries in the year earned and repeal of foreign tax credits currently allowed to American corporations or their subsidiaries. *See* American Enterprise Institute for Public Policy Research, Legislative Analysis: The Burke-Hartke Foreign Trade and Investment Proposal (1973) (mimeographed pamphlet). Although the Burke-Hartke bill now has little chance of enactment, the controversy continues over what effect the tax system can have on international balance-of-payments problems and domestic inflation and unemployment. *See Panel Discussions on the Subject of General Tax Reform Before the House Comm. on Ways and Means*, 93d Cong., 1st Sess., pt. 11, at 1671-1888 (1973); *cf.* Benoit, *The Attack on the Multinationals*, 7 COLUM. J. WORLD BUS., 15 (Nov.-Dec. 1972). Moreover, the DISC law itself has recently been criticized by individual members of the Senate Finance Committee and the House Committee on Ways and Means. The possibility of repeal, however, is presently remote. *See* BNA DAILY TAX REP., April 12, 1974, at G-1, April 23, 1974, at G-1, May 29, 1974, at G-2.

4. The Senate Finance Commitee has stated:

> Other major trading nations encourage foreign trade by domestic producers in one form or another. Where value-added or multistage sales taxes are used to any appreciable extent, the practice is to refund taxes paid by the exporter at the time of the export and to impose these taxes on importers. In the case of income taxes as well, however, most of the major trading nations have features in their tax laws which tend to encourage exports.

SENATE COMM. REP. 90. For discussion of foreign border tax adjustments, see Naylor and Hanson, *Some Observations Concerning the Operation of a DISC*, 50 TAXES 783-84 (1972), and K. DAM, THE GATT: LAW AND INTERNATIONAL ECONOMIC ORGANIZATION 210-21 (1970). For description of certain provisions in foreign direct tax systems that affect export transactions, see *Hearings on H.R. 10947 Before the Senate Finance Comm.*, 92d Cong., 1st Sess. 37-45 (1971) [hereinafter cited as *1971 Senate Hearings*].

5. Letter from the Acting General Counsel of the Treasury, Roy T. Englert, to Hon. Wilbur D. Mills, June 16, 1970, quoted in Anninger, *DISC and GATT: International Trade Aspects of Bringing Deferral Home*, 13 HARV. INT'L L.J. 391, 393, n.12 (1972). Article XVI, para. 4, bars contracting parties from granting any direct or indirect subsidy which would result in the sale of products for export at a price lower than the comparable price in the domestic market. Englert believed that since the DISC proposal allowed only tax deferral and not remission of, or exemption from, direct taxes, GATT would not be violated. Anninger argues strongly to the contrary.

6. I.R.C. § 993(d). The SENATE COMM. REP., at 103, provides that:

loan by a controlled foreign subsidiary to its domestic parent can be fully taxed as a distribution of earnings.[7] Thus, domestic producers are given an advantage over their American-owned foreign counterparts. Also, in this manner, a DISC may form an economic relation with its suppliers in which the DISC provides capital to finance the suppliers' facilities, inventory, and research and development.[8]

The DISC law seems to allow a significantly productive use of tax-deferred earnings. Nevertheless, some commentators have criticized the Internal Revenue Code provisions governing producer's loans, saying that the imposed limitations are so restrictive that they frustrate the loans' usefulness to both the DISC and its borrowers.[9] Much of their criticism is well founded because the DISC rules are quite complex and the Internal Revenue Service has been slow in issuing clarifications. These commentators, however, overlook some important practical aspects of producer's loans and ignore the Congressional intent behind the entire DISC enabling legislation as well.

> [A] DISC is to be permitted to loan its tax deferred profits back to its parent manufacturing company (or any other U.S. export manufacturing corporation), generally, as long as the cumulative amount loaned to any one borrower does not exceed the amount of the borrower's assets considered as being related to its export sales.

7. As to whether withdrawals of corporate funds by a stockholder constitute dividends or loans, *see generally* I.R.C. § 316(a); 4 CCH 1974 STAND. FED. TAX REP. ¶ 2377.654. Loans by controlled foreign subsidiaries to domestic parents are governed by I.R.C. sections 951(a)(1) and 956, which together specify that United States shareholders of controlled foreign corporations are taxed currently on their prorata share of that part of the increase in the corporation's yearly earnings which is invested in United States property. Section 956(b) of the I.R.C. and section 1.956-2(d)(2) of the Treasury Regulations (1964) define "United States property" to include an obligation of a United States person, such as a note or other indebtedness. The apparent theory behind taxation of foreign-source earnings brought back to the United States is that such earnings are substantially the same as a dividend.

8. U.S. DEP'T OF THE TREASURY, DISC: A HANDBOOK FOR EXPORTERS 2 (1972) [hereinafter cited as DISC HANDBOOK]. This informal pamphlet, published soon after the Revenue Act of 1971 was passed, also states at 20:

> Producer's loans are one of the main features of the DISC legislation as such loans enable the DISC to employ its tax deferred income productively. . . . Under the producer's loan concept a DISC may help finance U.S. production for export through loans of its accumulated DISC income to any related or unrelated U.S. producer for export. When a DISC is a subsidiary, producer's loans will typically be made to the parent corporation. . . . A producer's loan will not be treated as a constructive dividend.

9. Many commentaries have been written about DISCs, but only a few have addressed, and criticized to any significant degree, the complexity of producer's loans: W. BRUDNO & W. SWAYZE, DOMESTIC INTERNATIONAL SALES CORPORATIONS (DISC) A-13—A-15 (BNA Tax Management Pamphlet No. 264-2d, 1973) [hereinafter cited as BRUDNO & SWAYZE]; Golbert, *Pitfalls of DISC*, 55 MANAGEMENT ACCOUNTING 52, 54 (July, 1973); Richman, *Proposed DISC Regs: Maintaining DISC Status through Use of Producer's Loans*, 38 J. TAXATION 229 (1973); and Note, *Domestic International Sales Corporations—A Tax Incentive for Exporters*, 56 MINN. L. REV. 407, 417-22 (1972) [hereinafter cited as *DISC—A Tax Incentive*].

This Note will respond to the criticism of the current producer's loan arrangement.

I
PRINCIPAL FEATURES OF A DISC

A DISC is a corporation organized to sell goods and services abroad without engaging in any manufacturing activities.[10] Anyone may own shares of DISC stock, but since Congress intended a DISC to be the domestic equivalent of an American-controlled foreign subsidiary, domestic manufacturers and producers will most likely set up wholly-owned DISCs as foreign marketing agents.[11]

A DISC may export goods and materials which have been manufactured, produced, grown, or extracted in the United States by some business entity other than the DISC, and this "export property" must be held primarily for sale or lease in the ordinary course of the DISC's business for direct use, consumption, or disposition outside of the United States.[12] When the DISC purchases its export property, the Internal Revenue Code permits unusual flexibility in the pricing arrangements between the DISC and its suppliers, in lieu of the rules set forth under section 482 which prescribe "arm's length" standards.[13] Thus, a DISC may buy its inventory from a related or unrelated

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10. The DISC must be chartered under the laws of a state or the District of Columbia, and its shareholders must unanimously consent to have the corporation treated as a DISC in order to receive the special tax benefits. Moreover, the DISC is allowed to have only one class of capital stock outstanding during the entire year, with stated value of at least $2,500. I.R.C. §§ 992(a), (b). This low requirement for equity capital renders the DISC essentially immune to challenge on the basis of thin debt/equity capitalization. *See* Guttentag and Nauheim, *Proposed Regs Reflect Treasury's Desire to Make DISC Work But Questions Remain,* 37 J. TAXATION 56, 58 (1972).

11. SENATE COMM. REP. 103. Numerous business periodicals have indicated that DISCs will be operated as wholly-owned subsidiaries of domestic producers. *See e.g., Boom in DISCs: Hundreds of Firms Queue up to Cash in on the New Export Law,* BARRON'S, Aug. 28, 1972, at 9; *Exporters Scurry for the New Tax Break,* BUSINESS WEEK, Jan. 1, 1972, at 22.

12. I.R.C. §§ 993(c)(1)(A), (B). For discussion of what percent of export-related revenues and assets a DISC must have to maintain its tax-deferred benefits, see note 17 *infra.*

13. Generally speaking, section 482 applies to related business entities, such as a parent and its subsidiary where the parent owns part, or all of the subsidiary's stock, and where the two transact business between themselves. The section provides that if two or more businesses, whether or not incorporated, are owned or controlled directly or indirectly by the same interests, the Commissioner of Internal Revenue may allocate gross income and deductions between or among these businesses, if such an allocation is necessary to prevent evasion of taxes, or to reflect income more clearly. I.R.C. § 482. If a DISC were set up as a wholly-owned subsidiary, to market abroad the parent's products sold to the DISC, this arm's length provision and the Treasury Regulations promulgated under it would ordinarily apply, except for the special DISC rules described in note 14 *infra.*

domestic manufacturer at prices which allow the DISC to earn a greater profit on its sales than section 482 regulations would otherwise sanction.[14]

A DISC's most important characteristic is that it is not directly subject to United States corporate income tax on any of its profits, though part of its income is taxable to its shareholders.[15] Roughly one-half of the DISC's net income, plus all of the interest earned on producer's loans, all of the gain from the sale of certain depreciable assets or nonqualified export property, and any foreign investments attributable to producer's loans are "deemed" to have been distributed to DISC shareholders during a qualifying tax year.[16]

A DISC must receive at least 95 percent of its gross receipts from exports and certain export-related investments or activities, and it must use at least 95 percent of its assets either directly or indirectly in its export business.[17] If a DISC fails to satisfy the 95 percent gross receipts

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14. The Code establishes two complex intercompany pricing formulae to maximize these benefits. I.R.C. §§ 994(a), (b). The transfer price may be set so that the DISC can derive taxable income, attributable to the sale or lease of the transferred property, equal to the greater of the following: (a) 4 percent of the qualified export receipts of the DISC, plus 10 percent of the DISC's export promotion expenses comprised of the ordinary and necessary expenses incurred to obtain qualified receipts, or (b) 50 percent of the combined taxable income of the related supplier and the DISC from production and sale or lease of export property, plus the same 10 percent of promotion expenses of the DISC. Obviously, the transfer price can be determined under these formulae only after the DISC sells or leases the goods abroad. This implies that, in the intercompany allocation of income, the DISC and its related suppliers may make favorable closing adjustments on their books after the tax year has ended in order to maximize DISC profits and tax deferral.

15. I.R.C. § 991, 995(a).

16. I.R.C. § 995(b)(1). For example, a DISC with taxable income of $125,000, including $15,000 in interest from producer's loans and $10,000 of gain from the disposition of nonqualified assets, would be deemed to have distributed $75,000 to its shareholders. The $75,000 is equal to the sum of the producer's loan interest and the nonqualified gain, plus one-half of the remaining net income ($15,000 + $10,000 + .50($125,000 − $25,000)). This amount would be taxable to the shareholders whether or not actually distributed.

17. I.R.C. §§ 992(a)(1)(A), (B). To meet the 95 percent revenue requirement, the "qualified export receipts" of a DISC may include: the sale or lease of American-made goods; the sale or exchange of plant, equipment and other assets used by the DISC for the production of export income; compensation for the performance of services which are related and subsidiary to the sale or lease of export property; compensation for the performance of engineering and architectural services for overseas construction projects; interest on producer's loans, on trade receivables arising from the sale or lease of exported goods, and on obligations of the Export-Import Bank and Foreign Credit Insurance Association; and finally, dividends from investment in related foreign export corporations. I.R.C. § 993(a)(1). This listing gives some idea of the breadth of export activities DISCs may undertake. Ninety-five percent of a DISC's business assets must be "qualified export assets" which include the following: export inventory and goods held for sale or lease; fixed assets used for sales, leasing, or performance of services; trade receivables; working capital in the form of cash or temporary investments; producer's loans; investments in related foreign marketing corporations; obligations of the Export-

test, or the 95 percent export-related assets test, it may make certain deficiency distributions after the end of the tax year in order to maintain its DISC status.[18] If it fails to make these penalty distributions, it is disqualified, in which case all deferred taxable income is taxed to the shareholders over the following ten years, or over a shorter period if the corporation was a DISC for fewer years.[19]

II
PRODUCER'S LOANS

A. The Framework of the Producer's Loan Scheme

A DISC may use its tax-deferred accumulated income in numerous ways.[20] Perhaps the most important of these is the producer's loan by which the DISC lends its tax-deferred earnings to United States suppliers. These loans are not taxable, so that DISC income can productively be used entirely in the United States. In this respect, the DISC and its borrower have an advantage over American-controlled foreign subsidiaries, whose income may be taxed by the United States whenever it is repatriated and therefore must be kept abroad.[21]

In general, the borrower may be any person who, regardless of affiliation with the DISC, is engaged in the manufacture, production, growth, or extraction of goods for export.[22] The loan must be evidenced by a note or other indication of indebtedness, be designated a

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Import Bank and the Foreign Credit Insurance Association; and finally, bank deposits which are in excess of the DISC's reasonable working capital requirements and which are awaiting investment in other qualified export assets within the near future. I.R.C. § 993(b).

18. I.R.C. § 992(c). A qualifying distribution, to meet the gross-receipts requirement, consists of an amount equal to the DISC's net income multiplied by the ratio of its nonqualifying gross revenues to its total gross revenues. If less than 95 percent of a DISC's assets are qualified export assets, the fair market value of such assets must be distributed.

19. I.R.C. § 995(b)(2). A corporation may also revoke its election to be treated as a DISC and suffer the same tax consequences as disqualification.

20. For instance, a DISC may extend financing to its foreign customers, or build up its inventory of products to be exported, invest in office and warehouse facilities and other business property, pay its suppliers more promptly, or even invest in Export-Import Bank obligations. DISC Handbook, *supra* note 8, at 9, 20.

21. *See* notes 7 and 8 *supra* and accompanying text.

22. I.R.C. § 993(d)(1)(C). A person is related or unrelated to a DISC, depending on whether or not he owns DISC shares of stock and exercises some degree of control over the DISC. A DISC should be wary of lending funds to an unrelated entity because of the limits imposed on the loans, which are measured only by the borrower's assets and revenues. A DISC might fail to meet the 95 percent qualified export assets test because it is discovered too late that what was thought originally to be a producer's loan, in reality is not, due to facts known only to the borrower.

producer's loan, and have a maturity term of no more than five years.[23] Also, the loan must bear interest in accordance with section 482 regulations, which ordinarily require a rate between 4 and 6 percent.[24]

There are three specific limitations imposed by the DISC legislation which directly affect the amount of producer's loans.[25] First, when added to the unpaid balance of all the producer's loans made by a DISC, any given loan may not exceed the DISC's accumulated income as of the first day of the month in which the loan is made.[26] Second, when added to the unpaid balance of all producer's loans made to the same borrower by all DISCs, the loan may not exceed the amount of the borrower's export related assets as of the beginning of its tax year.[27] And third, when added to the unpaid balance of all other producer's loans made to the borrower during any given tax year by all DISCs, the loan may not exceed the borrower's increased investments during the year in net property, plant, and equipment, in all inventory used in the ordinary course of its business, and in research and experimental expenditures whether or not capitalized.[28]

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23. I.R.C. §§ 993(d)(1)(B), (D).

24. I.R.C. § 482; Treas. Reg. § 1.482-2(a) (1968). Subd. (1) of this part of the Treasury Regulation requires:

> [w]here one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group, and charges no interest, or charges interest at a rate which is not equal to an arm's length rate . . . the district director may make appropriate allocations to reflect an arm's length interest rate for the use of such loan or advance.

Subd. (2) defines an arm's length interest rate when the creditor is not regularly engaged in the business of making loans (as is the case for a DISC) as:

> (i) [t]he rate of interest actually charged if at least 4 but not in excess of 6 percent per annum simple interest, [or] (ii) 5 percent per annum simple interest if no interest was charged or if the rate of interest charged was less than 4, or in excess of 6 percent per annum simple interest. . . .

See Proposed Treas. Reg. § 1.993-4(a)(4), 37 Fed. Reg. 20,853 (1972); DISC HANDBOOK, *supra* note 8, at 20, 21.

25. The Senate Finance Committee agreed in general with the House that the main objective of the DISC law was "to provide substantial stimulus to exports and at the same time to avoid granting undue tax advantages to the DISCs," and that "the deferral treatment made available to a DISC should be limited." SENATE COMM. REP. 13, 91. The three limits on producer's loans were established to be consistent with this overall view.

26. I.R.C. § 993(d)(1)(A).

27. I.R.C. § 993(d)(2). This limitation shall be referred to as the "borrower's asset base requirement." This amount is determined by multiplying the sum of (1) the borrower's adjusted basis of plant, equipment, and supporting production facilities in the United States; (2) all of the borrower's inventory held for sale or lease; and (3) all of the borrower's domestic research and development expenditures during all preceding taxable years since 1971, by the ratio that the borrower's export sales bear to the borrower's total sales during the prior three tax years (but not including any tax year commencing before 1972).

28. I.R.C. § 993(d)(3). This limitation shall be referred to as the "borrower's increased investment requirement."

A simple example will demonstrate how these limitations work to restrict the amounts of producer's loans. Assume a DISC has accumulated income of $15,000 on June 1, 1975, at which time it also has outstanding $50,000 in producer's loans. Of this $50,000, some $25,000 is owed by the DISC's parent corporation, including $10,000 loaned in March 1975. The parent has no other producer's loans, and has export-related assets at the beginning of its tax year equal to $235,000. During the year, the parent has increased its investment in total net property, plant, and equipment from $1,750,000 to $1,830,000. Under these facts, the DISC could lend the parent $70,000 on June 1, 1975, equal to the least of the following: (a) the accumulated DISC income at the first of the month of the loan, less its producer's loans ($100,000); (b) the parent's amount of export-related assets on the first of the year, less the total amount of the producer's loans to the parent ($210,000); or (c) the parent's increased assets during 1975, less the other loans to the parent received and outstanding during the year ($70,000).

B. Criticisms of the Producer's Loan Scheme

1. *Borrower's Asset Base Requirement*

One criticism that has been leveled at the producer's loan scheme is that an American manufacturer, with some overseas operations, may not be eligible to borrow as much from DISCs as manufacturers of comparable, or even smaller size, operating exclusively within the United States.[29] This possibility exists because the borrower's asset base, under the export related assets limitation, is first reduced by the amount of the borrower's overseas assets and research and experimental expenditures, and is then multiplied by the percentage of total receipts attributable to sales of export property which, by definition, excludes goods produced abroad. Thus, if two firms export 100 percent of their domestic production, but one of the firms also produces abroad, the exclusively domestic manufacturer would be entitled to borrow a greater amount, although both firms might have domestic plants of comparable capacity and worth.[30]

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29. *See* Golbert, *supra* note 9, at 54; *DISC—A Tax Incentive, supra* note 9, at 418-20.

30. Consider two manufacturers which sell their output exclusively abroad. Company A with an adjusted basis of $500,000 in domestic assets would be permitted to borrow up to $500,000 (*i.e.* $500,000 × 100%) in producer's loans. Company B, on the other hand, has a total adjusted asset basis of $1,000,000, allocated between two identical plants, one

One commentator has written of this situation:

> [The Senate Finance Committee Report] indicates that the purpose of this limitation is to limit producer's loans to the amount of the borrower's assets considered "related to its export sales." Since the percentage of receipts attributable to sales of export property accurately measures the extent of the borrower's export activity, the purpose of the limitation would have been achieved without the additional requirement that the asset base be limited to assets located in the United States.[31]

The criticism is superficially plausible, but overlooks another important feature of the legislature's intent, namely that DISCs were created "to remove a present disadvantage of United States companies engaged in export activities through domestic corporations."[32] Congress intended DISCs to be the domestic equivalents of foreign manufacturing and sales subsidiaries, and therefore granted DISCs certain tax benefits—among them producer's loans—designed to alleviate the former tax discrimination suffered by domestic producers whose American-controlled counterparts abroad can postpone indefinitely United States taxation of profits.[33] Thus, it seems logical that American producers, the primary beneficiaries of the DISC law, should be entitled to use a greater share of a DISC's tax-deferred income than would be allowed to manufacturers producing both domestically and abroad. As further evidence of this underlying Congressional intent, it should be noted that a DISC which lends to a producer with foreign operations risks the possibility of having its loans lose their status as qualified export assets if the borrower is increasing its investments abroad. Should this occur, the amount of foreign investment attributable to producer's loans ("fugitive capital") will be deemed distributed to the DISC's shareholders.[34] Thus, even if a DISC could lend the same

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in the United States and one in France. Since only 50 percent of B's revenues are from the sale of export property, Company B may borrow only $250,000 (*i.e.* $500,000 × 50%), even though both companies have comparably valued domestic assets.

31. *DISC—A Tax Incentive, supra* note 9, at 419-20.

32. SENATE COMM. REP. 90.

33. *See* note 3 *supra*.

34. I.R.C. § 995(d). The Senate Finance Committee stated:

> The committee is concerned that the tax-deferred profits of a DISC which are loaned to the DISC's parent company (or affiliated company) may be used for investments in foreign plant and equipment by the parent (or domestic or foreign affiliate). To limit this possibility, it has provided that to the extent the controlled group, which includes the DISC, invests profits of the DISC in foreign plants and equipment, deferral is to cease with respect to the profits. The group will be treated as having invested the DISC profits in this manner to the extent the group's investments in foreign plant and equipment are in excess of specified amounts of foreign source capital of the group (generally, one-half the amount of the earnings of (and fees and royalties paid to domestic members of the group by) the foreign affiliates, the amount of capital—debt or equity

amount to a multinational producer as to an exclusively domestic one, it is unlikely that the DISC would in fact make such a loan.

2. Borrower's Increased Investment Requirement

A second criticism of the producer's loan scheme concerns the increased investment limitation, which requires that the borrower increase its net United States investment in specified activities during the year by an amount at least equal to its annual DISC borrowings. The legislative intent underlying this and the asset base requirement, was to prevent the loans from going into foreign investment and to insure that producers increase their exports in order to enjoy continued tax benefits.[35] Commentators are quick to point out, however, that a borrower may be unable to demonstrate that he has complied with the increased investment requirement, though in fact all loans have been used domestically.[36] For example, an investment early in the tax year may not appear on the books of the borrower by year end because of

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> —raised abroad by the group, and additions to foreign depreciation reserves by the group).

SENATE COMM. REP. 91-92. The Treasury Department also has written:

> In order to prevent the flow of tax deferred funds into foreign investment, the tax deferral on funds loaned by a DISC as producer's loans will end if the funds are deemed to have been invested overseas.

DISC HANDBOOK, *supra* note 8, at 22. *See* Rothkopf, *DISC: Qualifying under the New Export Income Laws: Advantages and Hazards*, 36 J. TAXATION 130, 136-37 (1972).

35. *See* note 34 *supra*. Speaking to the Senate Finance Committee prior to enactment of the DISC legislation, John S. Nolan, former Deputy Assistant Secretary of the Treasury for Tax Policy, argued:

> The important thing is to limit the extent to which the DISC profits can be used by the parent company, and we have limited the loans to producers to the proportion of the total investment in these kinds of manufacturing assets which the producer's export sales bear to its total sales, and we have required that there be an investment by the borrower in its U.S. assets in the amount of the borrowed funds in the year the loan is made.
>
> We think this is a reasonable and fair limitation. We further provide that the loans can be made for only a 5-year period so that this testing for any loan has to be redone every 5 years. We think this will insure that the company is maintaining or increasing its level of export sales or increasing its U.S. investment in order to continue to enjoy these benefits.

1971 Senate Hearings 18. As part of the record, the Treasury Department also submitted a lengthy prepared statement, part of which reads:

> Once the borrowing limit of a producer is reached, there can be no additional loans from a DISC unless the borrower either expands his percent of export sales or increases his U.S. plant, equipment and inventory, or his research and development expenditures. To the extent that the borrower neglects export expansion or invests abroad rather than at home, he limits his borrowing capacity from a DISC and this, in turn, reduces the possibility of continued use of DISC income in ways which qualify for tax deferral.

1971 Senate Hearings 47.

36. *See* note 9 *supra*: BRUDNO & SWAYZE at A-14, A-15; Golbert at 54; Richman at 230-31; *DISC—A Tax Incentive* at 420-21.

other events such as a sale of production equipment, accelerated depreciation charges, casualty losses, or a reduction in inventory due to unexpected demand. As a result, a producer's loan might be retroactively disqualified, requiring a deficiency distribution by the lending DISC.

These commentators have made a valid, though very technical, criticism. Neither the DISC legislation nor the Proposed Treasury Regulations governing producer's loans indicate whether Congress intended net decreases in investment attributable to depreciation charges or unexpected circumstances to be considered in determining if the increased investment requirement has been met.[37] However, the ambiguity may not be important. In practice, a United States manufacturer with both domestic and foreign markets to satisfy will probably not rely exclusively on DISC financing. Instead, it will use a carefully planned combination of producer's loans and other, more traditional sources of capital, such as retained earnings or bank loans. The growth in the producer's assets, stimulated by growing foreign and domestic demand for its products, and financed by all available capital sources, will likely be sufficient to meet the increased investment requirement.[38] Moreover, one of the important items in determining if the increased investment requirement has been satisfied is the producer's research and development expenditures, which are not ordinarily subject to unexpected loss or reduction by year end. These annual expenditures, plus the increased investment in net tangible assets, may easily satisfy the requirement. Also, if it appears that a producer's loan might be disqualified by the end of the year, and the borrower has extra cash on hand, it could repay the loan to the DISC. Then the DISC could invest in obligations of the Export-Import Bank or the Foreign Credit Insurance Association and maintain its qualified asset status, without suffering a deficiency distribution.[39] Nevertheless, until the Treasury Department specifies how it will treat involuntary contraction of producer's assets when the increased investment limitation is applied, DISCs should plan their loans carefully to avoid the possibility, however remote, of retroactive disqualification.

37. Proposed Treas. Reg. § 1.993-4, 37 Fed. Reg. 20,853 (1972). Moreover, there are no court decisions or Revenue Rulings which might clarify the problem.

38. The possibility of retroactive disqualification will arise only in the rare instance where producer's loans are the sole source of capital for a small, relatively static manufacturing concern.

39. *See* Cramer, *The DISC Corporation*, 9 CONFERENCE BOARD RECORD, Aug. 1972, at 59, 61, where this use of Eximbank and F.C.I.A. obligations is suggested. *See also* note 17 *supra*.

3. Renewal of Producer's Loans

The third principal criticism of the producer's loan scheme stems from the possible difficulties experienced by both the borrower and lender at the time of the loan's maturity. The Revenue Act of 1971 did not provide for renewal after the initial five-year period, but the Senate Finance Committee stated:

> If at its maturity the borrower's limitation is sufficient to permit a new loan in the amount of the old loan, then the old producer's loan could be renewed for an additional stated period of up to 5 years and then would qualify as a producer's loan for that period.[40]

From this language, it appears that the tests applicable when the loan was first made must be reapplied if a renewal is to be effected. Indeed, the Proposed Treasury Regulations provide that a renewal will be treated as an entirely new loan, which entails full repayment of the old loan, and formal refinancing of the new debt.[41]

Such exacting rules for extension of the producer's loans, critics are quick to point out, would effectively negate the ability of many borrowers to renew.[42] This criticism is valid, if it is assumed that Congress intended DISC tax deferral to be indefinite. The borrower presumably will have invested the original proceeds so that it may have to obtain funds from other sources to make repayment. And the borrower may no longer be able to meet the export-related assets or increased investment requirements at the time of renewal, even if it has the funds available for repayment. These criticisms, however, overlook the underlying Congressional intent and an important practical feature of the current producer's loan arrangement. The entire DISC program is based on tax deferral, not tax reduction. To allow producer's loans derived from untaxed earnings to be renewed for indefinite periods of time would essentially render those earnings tax exempt. Moreover, reapplication of the loan tests every five years will force borrowers to maintain or increase their levels of export sales, or to increase their domestic investments in plant, equipment, inventory, and research and development in order to assure continued enjoyment of the special tax benefits.[43] In practice, if a borrower cannot meet these tests and is therefore required to refinance, it will have saved substantial interest charges, in any event, by using producer's loans for five years, instead

40. SENATE COMM. REP. 104.
41. Proposed Treas. Reg. §§ 1.993-4(a)(2)(v), (a)(4), 37 Fed. Reg. 20,853 (1972).
42. *See* note 9 *supra*: BRUDNO & SWAYZE at A-15; Golbert at 54; Richman at 231-32; *DISC—A Tax Incentive* at 422.
43. *See* testimony of John S. Nolan, former Deputy Assistant Secretary of the Treasury for Tax Policy, *1971 Senate Hearings* 18, quoted in note 35 *supra*.

of ordinary short term bank loans. Section 482 regulations prescribe an interest rate of 4 to 6 percent for intercompany loans, while a bank loan would currently cost 8 to 10 percent.[44] If the borrower is also the DISC's sole shareholder, the producer's loan is an interest-free transaction, assuming that the interest paid is actually distributed to the DISC's borrower-shareholder.[45] Thus, even if the borrower has to repay a producer's loan at its maturity date with outside funds, it will have postponed incurrence of higher interest rates and saved a considerable expenditure.

CONCLUSION

The Revenue Act of 1971 created an important incentive for American foreign traders, permitting taxes on profits from export sales through DISCs to be partially deferred. The value of this legislation would be largely illusory, however, if producers could not avail themselves of the tax-deferred profits in the expansion of their domestic operations. Producer's loans are an important means of utilizing these earnings.

Congress, however, did not intend to leave the productive investment of DISC profits unrestricted. The major thrust of legislative thinking was partial tax deferral, not complete and permanent tax reduction. Therefore, certain limitations were prescribed to control borrowing of DISC accumulated earnings. When these limitations are transgressed, tax liability is incurred. The imposition of these conditions appears entirely consonant with legislative purpose. Moreover, from an operative point of view, the present scheme for producer's loans is not unreasonably burdensome when it is remembered that domestic producers without foreign manufacturing operations are the primary beneficiaries of the DISC law, that those producers, with local as well as foreign markets to satisfy, will probably not rely exclusively on DISC financing in their efforts to raise capital, and that the recipients of producer's loans will realize great interest savings despite the short maturity term and difficulties in renewal of the loans.

Edwin S. Hetherington

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44. I.R.C. § 482; Treas. Reg. § 1.482-2(a) (1968). The relevant provisions are discussed at note 24 *supra*. For example, the annual interest on a $200,000 loan at 4 percent is $8,000, whereas, at 8 percent it is $16,000. The present value of these payments over five years is approximately $35,600 at 4 percent and $64,000 at 8 percent. In effect, by borrowing from a DISC instead of a bank, the producer is immediately realizing, on a pre-tax basis, a saving of over $28,000 on a $200,000 loan.

45. *See* DISC HANDBOOK *supra* note 8, at 21. As discussed in note 16 *supra* and accompanying text, interest on producer's loans is "deemed" distributed by the DISC to its shareholders.