A TAX ANALYSIS OF DOMESTIC INTERNATIONAL SALES CORPORATIONS (DISC): THE CASE OF THE SLIPPED DISC?

In 1971, Congress outlined seven problem areas considered to have an adverse effect on the economy.[1] These areas are spiraling inflation, declining growth in real gross national product, a severe downward trend in the economy, insufficient expenditures for new capital equipment, a worsening balance of payments deficit, a declining balance of trade position and a weakening of the U.S. dollar.[2] As a means of ameliorating these problems, Congress enacted the Revenue Act of 1971.[3] Embodied within that Act, is the Domestic International Sales Corporation (DISC) legislation.[4] This legislation encourages a DISC to manufacture within the United States[5] by exempting its retained earnings from federal income tax.[6]

Notwithstanding this incentive, the DISC legislation seems to have failed to achieve its intended purposes.[7] Instead of stimulating the economy, it has primarily aided the large exporters.[8]

1. U.S. CODE CONG. & ADM. NEWS, 92d Cong., 1st Sess. 1825 (1971).

2. *Id.*

3. Revenue Act of 1971, Pub. L. No. 92-178, 85 Stat. 497 (1971) [hereinafter cited as Act].

4. INT. REV. CODE OF 1954, §§ 991-97.

5. U.S. CODE CONG. & ADM. NEWS, 92d Cong., 1st Sess. 1996 (1971).

6. The shareholders are ultimately liable for any tax obligation accruing from any distribution made by a DISC. A DISC will be deemed to have made a distribution in the form of a dividend to its shareholders of 50% of its income which is earned during the taxable calendar year. The remaining 50% of DISC income and profits may continue to accumulate in the corporation subject to taxation only upon an actual distribution or distribution upon disqualification. INT. REV. CODE OF 1954, §§ 991, 995(b)-(b)(2), 996(a)(1).

7. For an assessment of the effectiveness of the Domestic International Sales Corporation (DISC) Legislation, which suggests that the large DISC's are exporting scarce domestic products, see COMMITTEE ON WAYS AND MEANS U.S. HOUSE OF REPRESENTATIVES, 93d CONG., 2d SESS., FIRST ANNUAL REPORT OF THE DEPARTMENT OF THE TREASURY ON THE OPERATION AND EFFECT OF THE DOMESTIC INTERNATIONAL SALES CORPORATION LEGISLATION (Comm. Print 1974) [hereinafter cited as DISC Report]. This report is an in-depth analysis of the product lines exported by DISC's and their relative profitability ratio. GENERAL ACCOUNTING OFFICE, REPORT TO THE HON. CHARLES A. VANIK (OHIO) ON DISC's BEING USED AS TAX LOOPHOLES IN WHEAT AND AGRICULTURAL TRANSACTIONS, (Unpublished Report May 29, 1974) [hereinafter cited as GAO Report].

8. *See* DISC Report, note 7, *supra*.

These exporters have organized DISC's and used them to export scarce domestic products.[9] Due to increased worldwide demand for these products, the DISC's are receiving inflated prices and deferring the tax obligation from the coresponding sales.[10] Moreover, since DISC's have not reduced their prices, consumers are not commensurately benefiting.[11]

This comment will analyze the DISC regulations and their effects on the economy. In addition, seven proposals will be suggested in order to improve this legislation.

I. WHAT IS A DISC?

A DISC is an exporting corporation exempted from federal income tax.[12] Accordingly, exporters find them attractive vehicles for conducting their business abroad.[13]

A corporation[14] which chooses to become a DISC, may select from two different types of organizations.[15] The first, a "buy-sell" DISC, operates like any other exporting corporation. It purchases, maintains and sells its inventory to foreign consumers. The second, a "commission" DISC, is an accounting entity[16] which permits the exporter to take advantage of these tax laws.[17] A

9. *See* GAO Report, *supra* note 7, at 2.

10. *Id.*

11. *See* DISC Report, note 7, *supra.*

12. INT. REV. CODE OF 1954, § 991.

13. 120 CONG. REC. E 1920 (daily ed. Mar. 28, 1974) (remarks of the Hon. Charles A. Vanik).

14. To qualify as a DISC, the corporation must almost exclusively engage in export transactions. In rare situations, DISC status will be granted to corporations providing certain specialized services abroad. A corporation previously engaged in exportation can generally qualify once it has satisfied the requirements imposed by this section. Likewise, a newly formed corporation will similarly qualify once these requirements are fulfilled. *See generally* INT. REV. CODE OF 1954, §§ 992, 993.

15. Regardless of the structure selected, both the "buy-sell" and "commission" DISC must comply with identical regulations. The only difference is in the DISC's substance; the tax benefits are the same.

16. A "commission" DISC has no tangible corporate substance. Rather, it is an entity existing in accordance with present tax regulations. Thus, it has been referred to as a "paper" corporation. HOUSE COMM. ON WAYS AND MEANS, PANEL DISCUSSION ON GENERAL TAX REFORM, H.R. DOC. No. 2, 93d Cong., 1st Sess. 5-8, 20, 22-23, 26-28 (1973) [hereinafter cited as Tax Reform Discussions]. Nevertheless, the Treasury Department has approved this form of organization. Proposed Treas. Reg. § 1.992-1(a), 37 Fed. Reg. 10368 (1972).

17. See authorities cited in note 16, *supra.*

"commission" DISC deals solely in trade receivables and consequently does not maintain an independent inventory.[18] Thus, it acts as a conduit between the parent corporation (its related retail supplier) and the customer. Although a "commission" DISC lacks the usual requirement of corporate substance,[19] it is nevertheless recognized as an acceptable method of conducting business.[20]

In order to qualify as either a "buy-sell" or "commission" DISC, the following five requirements must be satisfied.[21] First, the applicant must be a domestic corporation[22] engaging almost exclusively in export transactions.[23] Second, it can issue only one class of stock.[24] Third, the par or stated value of the outstanding shares must equal or exceed $2,500.00 on each day of the taxable year.[25] Fourth, it must file a notice of election with the Internal Revenue Service to be taxed as a DISC.[26] Fifth, at the conclusion of its calendar year, 95% of its assets must be invested in *qualified export assets*,[27] and 95% of its gross receipts must con-

18. *Id.*

19. Corporate substance includes directors, employees, corporate headquarters, inventory and other tangible items. *See* Proposed Treas. Reg. § 1.992-1(a), 37 Fed. Reg. 10368 (1972).

20. Rev. Rul. 72-166, 1972-1 CUM. BULL. 466; Proposed Treas. Reg. § 1.993-1(l), 37 Fed. Reg. 10368 (1972); Proposed Treas. Reg. § 1.992-1(a), 37 Fed. Reg. 10368 (1972). *See also* H.R. REP. No. 533, 92d Cong., 1st Sess. 60 (1971); S. REP. No. 437, 92d Cong., 1st Sess. 93 (1971). Regardless of the structure selected, both the "buy-sell" and "commission" DISC must comply with identical regulations. *See generally* Rendell, *Use of a DISC to Reduce Federal Income Tax on Export Earnings*, 11 SAN DIEGO L. REV. 138, 145 (1973) [hereinafter cited as Rendell].

21. INT. REV. CODE OF 1954 § 992.

22. Only domestic corporations duly organized in the continental United States may elect DISC status. To be eligible for the preferential tax treatment, the electing corporation cannot previously have been or subsequently become a tax exempt organization, personal holding company, specified type of financial institution, insurance company, regulated investment company or tax option Subchapter "S" corporation. INT. REV. CODE OF 1954, § 992(d); *see* Proposed Treas. Reg. § 1.992-1(a), 37 Fed. Reg. 10368 (1972).

23. INT. REV. CODE OF 1954, § 992(a)(1)(A).

24. *Id.*, § 992(a)(1)(C).

25. *Id.*

26. *Id.*, § 992(b)(1).

27. A *qualified export asset* must reasonably relate to the business of exportation. *See generally* INT. REV. CODE OF 1954, §§ 992(a)(1)(B), 993(a)-(c).

A unique example of a *qualified export asset* is that which the Internal Revenue Service categorizes as a Producer's loan. This is a loan made by a DISC to its related retail supplier or manufacturer. Although normally not construed as an export asset, the Act specifically classifies this kind of transaction as a *qual-*

sist of *qualified gross receipts.*[28]

If a DISC fails to comply with any of these five requirements, it will be so notified by the Internal Revenue Service and its tax exempt status will be subject to revocation or suspension.[29] If a DISC ignores this notification, its tax exempt status will be revoked.[30] Thereafter the DISC must make a *distribution upon disqualification*[31] to its shareholders. This is a distribution of funds accumulated in the DISC which are taxable to the shareholders on a special basis.[32]

Alternatively, if the DISC complies with the notification,[33] its tax exempt status will be continued.[34] There are two acceptable methods of compliance. The first applies only in "non-mone-

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ified export asset. This kind of transaction is generally not reported as an export asset because the Internal Revenue Service frequently recognizes loans made by a corporation to its shareholders as dividends. As such, it constitutes a reduction in paid-in capital. However, the Act provides that this loan transaction may be recognized as a *qualified* capital *export asset.* INT. REV. CODE OF 1954 § 993(d).

In most cases the DISC is making the loan to its parent corporation which is its related retail supplier. The obligor must receive from the obligee a written promissory note with a stated maturity date not to exceed five years from the date of the making of the loan. The obligation must clearly state that it is a Producer's loan; there are complex limitations on the amounts available for loan purposes. INT. REV. CODE OF 1954, §§ 993(d)(1)(B), 993(d)(1)(C), 993(d)(2)-(4). *See also* Proposed Treas. Reg. § 1.953-4(a)(2)(1), 29 Fed. Reg. 18207 (1964).

28. A *qualified export receipt* must result from an export transaction. The electing corporation must maintain at least 95% of its gross receipts in *qualified export receipts.* The adjusted basis of the *qualified export assets* of the electing corporation at the close of the taxable year must equal or exceed 95% of the sum of the adjusted basis of all assets of the corporation at the close of the taxable year. INT. REV. CODE OF 1954, §§ 992(a)(1)(B); 993(a), (b), (f).

29. INT. REV. CODE OF 1954, § 992(c)(1).

30. A DISC has 5 years in which to correct any deficiency which the Internal Revenue Service has so pronounced. During this period, the DISC's tax status is suspended. If the DISC does not rectify its deficiencies within the five year period, its tax status will be revoked. INT. REV. CODE OF 1954, §§ 992(b)(2)-(3)(B).

31. When a DISC tax status is revoked, any retained earnings and working capital must be distributed to its shareholders. This is an *actual distribution* and is taxable as a dividend to the shareholders. For a more detailed discussion see INT. REV. CODE OF 1954, §§ 995(b)(2), (b)(2)(A), 996(f); Proposed Treas. Reg. § 1.996-3(b), 39 Fed. Reg. 35121 (1974).

32. This tax will be due in equal annual installments, over a 10 year period or the aggregate number of years which the DISC has been in existence, whichever period is shorter. INT. REV. CODE OF 1954, §§ 995(b)(2)(A)-(D).

33. A DISC will receive a letter from the Internal Revenue Service notifying it of any deficiency.

34. INT. REV. CODE OF 1954, § 992(c)(1).

tary"[35] situations. In these cases, the DISC must succumb to the requests of the Internal Revenue Service. The second involves strictly "monetary"[36] considerations, wherein the DISC must make a *deficiency distribution* to maintain its favorable tax status.[37] In making such a distribution, the DISC must apportion all of its income or assets in excess of the 5%[38] *non-qualified* limitation, to its shareholders.[39] Thus, when a DISC's *non-qualified* gross receipts slightly exceed 5%, all of the income attributable to those receipts must be recognized by the shareholders as dividends.[40] Likewise, if a DISC's *non-qualified* assets, computed on an adjusted basis at the close of its taxable year slightly exceed 5%, all of the *non-qualified* assets in excess of this limitation must be liquidated.[41] These funds are taxable to the shareholders as dividends.[42]

Assuming, however, the five conditions[43] previously discussed are met, the next step is to determine the amount of in-

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35. A "non-monetary" situation involves a failure to comply with any of the following requirements: A DISC must be a domestic corporation engaging exclusively in export transactions; it can issue only one class of stock; the par or stated value of the outstanding shares must equal or exceed $2,500.00 on each day of the taxable year; it must file a notification of election with the Internal Revenue Service to be taxed as a DISC. *See* notes 22-26, *supra*.

36. A "monetary" situation involves the failure to comply with the 95% *qualified export assets* and *gross receipts* test. *See* notes 27-28, *supra*.

37. A *deficiency distribution* is a *deemed distribution* of all *non-qualified assets* or *receipts*. The effect of a deficiency distribution, in most circumstances, will permit the DISC to maintain its preferential tax status. Nevertheless, there is a possible undesirable financial impact when a *deficiency distribution* is initiated to compensate for excess *non-qualified* assets. This is primarily because the fair market value of the assets being sold is immaterial. Hence, if the assets being liquidated are recorded on the books of the DISC at less than fair market value due to depreciation, amortization, inflation, or other reasons, the resulting sale will yield income greater than is otherwise necessary to satisfy this requirement. The harshness of this adjusted basis rule is tempered by the fact that this test is only required on an annual basis. Accordingly, this permits a DISC to shift around the percentage of its *qualified* and *non-qualified* assets throughout the year. INT. REV. CODE OF 1954, § 992(c)(1)(A)-(C).

38. This 5% limitation is the amount of *non-qualified assets* or *gross receipts* which a DISC may maintain to avoid violation of the 95% *qualified export assets* and *gross receipts* test. INT. REV. CODE OF 1954, § 992(a)(1)(A), (a)(1)(B).

39. *See* note 37, *supra*.

40. This dividend is taxable as a *deemed distribution*. INT. REV. CODE OF 1954, § 995(b)(1). For a more detailed discussion, see note 37, *supra*.

41. INT. REV. CODE OF 1954, § 992(e)(1).

42. *See* note 40, *supra*.

43. *See* notes 22-28, *supra*.

come a DISC may earn from each transaction. This question may be resolved by applying the intercompany pricing rules[44] which provide three alternate methods of computing the DISC's income.

The first method is the 4% rule,[45] which permits the DISC to earn 4% of the *qualified export receipts* from the transaction, plus 10% of its export promotion expenses.[46]

The second method is the 50% rule.[47] This entitles the DISC to earn 10% of its export promotion expenses, plus 50% of the combined taxable income from the transaction.[48] The combined taxable income is derived from the transaction between the DISC and its related retail supplier.[49]

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44. Since a DISC is not subject to taxation, these dividend distributions generally are not entitled to the intercorporate dividends received deductions provided by § 243. The intercorporate dividends received deduction will be available to the extent the DISC makes a distribution out of earnings and profits other than accumulated DISC income or previously taxed income. INT. REV. CODE OF 1954, §§ 246(d), 995(b)(1); Proposed Treas. Reg. § 1.246-4, 38 Fed. Reg. 20824 (1973).

45. INT. REV. CODE OF 1954, § 994(a)(1).

46. This rule may become clearer with an example involving the sale of export property by a "commission" DISC. Assume P sells 100 units of export property for $1,000 and designates its DISC to act as commission agent with respect to the sale. P's cost attributable to the 100 units is $620. Its direct selling expenses are $130 and its other indirect expenses (such as administrative overhead) apportioned to the sale are $100. The DISC pays $100 which qualifies as export promotion expenses, to independent contractors. The commission which the DISC can earn on the transaction is computed as follows:

(1) Combined taxable income:		
(a) P's sale price		$1,000.
(b) Less deductions:		
P's cost of goods sold	$620.	
P's direct selling expenses	130.	
P's indirect selling expenses	100.	
DISC's export promotion expenses	100.	
Total deductions		$ 950.
(c) Combined taxable income		$ 50.
(2) DISC's profit under the 4% rule:		
(a) 4% of P's sale price		$ 40.
(b) Plus 10% of its export promotion expenses		10.
(c) DISC's profit		$ 50.

The foregoing example appears in Rendell, *supra* note 20 at 155.

47. INT. REV. CODE OF 1954, § 994(a)(2).

48. Both the 4% and 50% methods are subject to the "no loss" rule which prevents the related retail supplier from recognizing a carry-over loss from the transaction. Rendell, *supra* note 20, at 144.

Neither of these methods, however, is subject to § 482 of the Internal Revenue Code unless its imposition results in a more favorable tax posture for the taxpayer. Proposed Treas. Reg. §§ 1.994-1(a), 1.994-1(e)(2), 39 Fed. Reg. 36009 (1974).

49. The following example demonstrates how the 50% rule works. Assume the facts stated in note 46, *supra*.

The third method is the marginal costing rules.[50] Under this method of allocating costs between the export transactions and other gross receipts, only direct material costs, direct labor and export promotion expenses claimed by the DISC need be deducted from the gross receipts in determining its taxable income.[51] The extent to which these amounts may be allocated to the DISC is dependent upon the overall profit limitation.[52] This limitation is computed by dividing taxable income by total sales.[53]

The marginal costing rules may permit a DISC to earn substantially greater profit than could otherwise be earned by utilizing either the 4% or 50% rule. Congress has recognized this, and accordingly, has urged that this accounting procedure be used only when a DISC is seeking to establish or maintain a market in ex-

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(3) DISC's profit under the 50% rule:	
(a) 50% of combined taxable income	$ 25.
(b) Plus 10% of its export promotion expenses	10.
(c) DISC's profit	$ 35.

This example appears in Rendell, *supra* note 20, at 155.

50. For a more complete discussion of marginal costing rules, see Rendell & Norman, *DISC—Marginal Costing and Other Recent Developments*, TAX MANAGEMENT MEMORANDUM 73-06 (March 19, 1973); Kauder, *Marginal Costing for DISC's: An Explanation and Analysis of Treasury's Proposed Regulations*, 38 J. TAXATION 304 (1973); Kauder, *When is Special Marginal Costing Beneficial?*, 39 J. TAXATION 51 (1973); Proposed Treas. Reg. §§ 1.994-1(e)(1)(ii), 1.994-2(b)(2), 39 Fed. Reg. 36009 (1974). *See especially* Treas. Reg. § 1.471-11, 38 Fed. Reg. 26185 (1973).

51. The DISC's taxable income and its related retail supplier's taxable income are functionally synonymous. *See generally* Proposed Treas. Reg. § 1.994-2(b)(2) and Treas. Reg. § 1.471-11, 38 Fed. Reg. 26185 (1973).

52. Proposed Treas. Reg. §§ 1.994-2(b)(3), 1.994-2(c)(2), 39 Fed. Reg. 36009 (1974).

53. The following example demonstrates how the marginal costing rules work. Assume the facts stated in note 46, *supra*, as well as the following information: P sells 300 additional units of the same product line for domestic consumption. The gross receipts from the 300 units is $3,000 and the profit on these sales, computed under full costing is $310. The overall profit percentage limitation would be computed thusly:

(4) DISC's profit under marginal costing:			
(a) Gross receipts from sale		$1,000.	
(b) overall profit percentage:			
(i) taxable income from all sales	$ 360.		
(ii) Gross receipts from all sales	4,000.		
(iii) (i) divided by (ii)		× .09	
(c) Overall profit limitation:			
(a) multiplied by (b) (iii)			$ 90.

This example appears in Rendell, *supra* note 20, at 162.

port property.[54] Nevertheless, the Department of the Treasury has ignored this recommendation by permitting application of the marginal costing rules in cases other than those described above.[55]

Regardless of the profit earned by a DISC, there are two limitations on the amount that may be accumulated as retained earnings. These two limitations are called *deemed distributions.*[56] The first requires that 50% of its profit be distributed to its shareholders as a dividend.[57] The second requires that any income from foreign investments attributable to producer's loans[58] be distributed as a dividend to its shareholders.[59]

The remaining profit may accumulate in the DISC as retained earnings. These retained funds are not taxable so long as they remain in the DISC.[60]

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54. *See* H.R. REP. No. 533, 92d Cong., 1st Sess. 60 (1971); S. REP. No. 437, 92d Cong., 1st Sess. 93, 108 (1971).

55. *See* Proposed Treas. Reg. § 1.994-2(c)(1), 39 Fed. Reg. 36009 (1974); *see especially* Treas. Reg. § 1.4882-2(4)(2)(iv) (1973). For limitations on this rule see Proposed Treas. Reg. §§ 1.994-2(a), 1.994-2(b)(1), 39 Fed. Reg. 34408 (1974).

56. A *deemed distribution* is a distribution made by a DISC in order to maintain its tax exempt status. This distribution is made when a DISC fails to satisfy the 95% *qualified export asset-gross receipt* test or when its retained earnings may not be accumulated in the DISC. A producer's loan is considered a *deemed distribution* by the DISC and income from that loan is known as *fugitive* capital. INT. REV. CODE OF 1954, § 995(b); Proposed Treas. Reg. §§ 1.991-1(b), 1.996-8, 39 Fed. Reg. 35125 (1974).

57. The gross profit is computed in accordance with the intercompany pricing rules. Fifty percent of this profit plus any income attributable to Producer's loans must be distributed and taxed as a dividend. INT. REV. CODE OF 1954, § 995(b)(1)(D).

58. INT. REV. CODE OF 1954, § 995(b)(1)(E).

59. *Id.*, § 995(b)(1); *see also* note 44, *supra.*

60. The following example demonstrates the accounting procedure necessary to determine the amount of retained earnings which may be accumulated, tax free, in the DISC. Assume the facts stated in notes 46, 49 and 53, *supra.* Assume also that each DISC earns $10 from foreign investments attributable to Producers' loans.

DISC "A"		*DISC "B"*		*DISC "C"*	
Profit computed using the 4% Rule:	$35.00	Profit computed using the 50% Rule:	$50.	Profit computed using the Marginal Costing Rules:	$90.
Foreign investment income:	$10.00	Foreign investment income:	$10.	Foreign investment income:	$10.
Total profit:	$45.00	Total profit:	$60.	Total profit:	$100.

If any retained earnings or working capital are withdrawn from the DISC for purposes other than to wind up or dissolve the business, the transaction will be considered an *actual distribution*,[61] taxable to the shareholders as dividends.[62] If, however, these funds are withdrawn to wind up or dissolve the DISC, they will become taxable to the shareholders on a deferred basis.[63]

Clearly, the exporter can derive tax benefits from the DISC legislation. Yet this legislation was not intended merely to aid exporters. Therefore, it must be determined what effect the legislation has had on the economy.

II. EFFECT OF THE DISC LEGISLATION

Though the DISC legislation was enacted as a means of stimulating a lagging economy, it does not appear to have succeeded. Specifically, its impact upon the seven major problems outlined by Congress[64] has failed to achieve the desired goals. Moreover, there exists a possibility that increased use of "commission" DISC's may permit abuses not anticipated by Congress.

The effect of this legislation has been to reduce treasury revenues below projected levels,[65] and it has contributed to increased domestic shortages of scarce products.[66] Further, the legislation has frustrated the congressional intent[67] by substantially benefiting

Distribution to shareholders: (50% of $35 plus $10.):	(27.50)	Distribution to shareholders: (35% of $50 plus $10.):	(35.)	Distribution to shareholders: (50% of $90 plus $10.):	(55.)
Retained earnings (non-taxable):	$17.50	Retained earnings (non-taxable):	$25.	Retained earnings (non-taxable):	$45.

61. An *actual distribution* is any distribution other than a *deemed distribution*, where the assets of the DISC are disbursed to the shareholders. An example of an *actual distribution* would be a *distribution upon disqualification*. INT. REV. CODE OF 1954, §§ 996(a), 996(a)(1)-(3).

62. This dividend must be recognized in the year it is distributed. INT. REV. CODE OF 1954, § 996(d)(1)(B).

63. This is considered a *deemed distribution* and taxable as a dividend. This tax will be due in equal annual installments, over a ten year period, or the aggregate number of years a DISC has been in existence, whichever period is shorter. INT. REV. CODE OF 1954, §§ 995(b)(2)(A), 995(b)(2)(B).

64. *See* text accompanying note 2, *supra*.

65. *See* GAO Report, *supra* note 7, at 3.

66. *Id.*

67. It was the congressional intent to aid both the large and small exporter. U.S. CODE CONG. & ADM. NEWS, 92d Cong., 1st Sess. 1825 (1971).

the larger exporting DISC, rather than all DISC's.[68]

The precarious state of the economy can be demonstrated by the following indicators: a balance of payments deficit of $2.7 billion in the second quarter of 1974;[69] a $1.6 billion decline in the balance of trade for that same period;[70] a $1 billion increase in U.S. investment abroad in the first half of 1974 as compared with the same period of 1973;[71] continued inflation;[72] and an unemployment rate which remains well above the target level of 4%.[73]

Notwithstanding these negative features, there have been small, though sporadic, increases in exports since 1971.[74] The DISC Report[75] and GAO Report[76] indicate that the DISC legislation did not materially contribute to these minor export increases.[77] These reports conclude that increased export sales were the result of two previous currency devaluations, domestic price controls and increased inflation abroad.[78] Thus, the DISC legislation does not appear to have directly and significantly increased foreign sales.

Despite these increased foreign sales, a substantial number of American products are not competitive in the world marketplaces.[79] The only area in which American goods are competitive is in the sale of scarce products.[80] This area has shown increased sales because world demand exceeds supply. The increased demand allows DISC's to price their exports above comparable foreign-made goods without a major decrease in sales.[81] It seems that the DISC legislation has not helped to lower most American export prices.

Not only has the DISC legislation failed to meaningfully

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68. *See* DISC Report, *supra* note 7 at 8, 10-12, 14.
69. L.A. Times, Sept. 19, 1974, at 1, col. 5.
70. *Id.*
71. *Id.*
72. L.A. Times, Jan. 17, 1975, at 1, col. 5.
73. L.A. Times, Jan. 4, 1975, at 1, col. 5, reporting unemployment rate of 7.1%.
74. *See* DISC Report, *supra* note 7, at 1.
75. *See* DISC Report, note 7, *supra.*
76. *See* GAO Report, note 7, *supra.*
77. *See* DISC Report and GAO Report, note 7, *supra.*
78. *See* DISC Report, *supra* note 7, at 1.
79. *Id.*
80. *See* GAO Report, *supra* note 7, at 2.
81. *Id.*

increase domestic productivity and foreign sales,[82] but a segment of the Revenue Act which provides for "commission" DISC's, may have an inherently negative aspect. That aspect consists of the lack of organic structure of the "commission" DISC, which, unlike other corporations, need not have any tangible substance.[83] It may exist in contemplation of tax and corporate laws, acting merely as a conduit between the manufacturer and the purchaser.[84]

> The tax law, as in the case of corporation law, has generally recognized the corporate fiction provided that the individuals deal at arm's length with the corporate entity. But Congress, in enacting the DISC provisions, intended the DISC to be a container for a mere bookkeeping account, without necessarily having its own employees, business facilities, or independent economic justification. The DISC's income, in effect, can merely be assigned to it in a transaction that need have no economic substance or reality so long as it is within the formula amounts permitted by the DISC pricing provisions.[85]

Thus, it is merely an accounting entity, not a corporation having corporate substance.[86]

A "commission" DISC's lack of corporate substance and autonomy can be a negative feature because its assets can be used to distort the balance sheets and income statements of its related retail supplier.[87] These possible distortions are evident in three areas.[88] First, the assets and liabilities of a "commission" DISC can easily be commingled with those of the parent corporation,[89] due to the close connection between these two entities. Second, the parent corporation could underpay its DISC by remitting its commission in doubtful or overstated accounts receivable.[90] Third, if understated accounts receivable are sold to the DISC,

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82. *See* Tax Reform Discussions, note 16, *supra*.

83. A DISC which otherwise would not meet the requirements of a corporation will nevertheless be deemed a separate corporation for income tax purposes. Rev. Rul. 72-116, 1972-1 CUM. BULL. 466; Proposed Treas. Reg. §§ 1.992-1(a), 1.993-1(*l*), 37 Fed. Reg. 10368 (1972). *See also* H.R. REP. NO. 533, S. REP. NO. 437, note 20, *supra*; Rendell, *supra* note 20, at 145.

84. *See* authorities cited in note 83, *supra*.

85. Fisher, Kohl & Knox IV, *With Proper Planning, Deferred Ordinary Income of a DISC Need Never be Recaptured*, 40 J. TAXATION 138, 140 (1974).

86. *See* note 19, *supra*.

87. *See* Tax Reform Discussions, *supra* note 16, at 1719-31.

88. *Id.* at 1716-32.

89. *Id.*

90. *Id.*

this will result in an overpayment of its commission.[91] The overall impact of these possible abuses could foster inaccurate financial reporting by both the DISC and its parent corporation.

Nevertheless, this form of organization is absolutely lawful and valid. The "commission" DISC is specifically provided for by the tax code, and the Treasury Department has given its approval to this kind of corporation.[92]

A "commission" DISC has at least one positive aspect. Exporters favor its lack of corporate substance because it minimizes operational costs.[93] Lower costs should encourage greater profits and reduce export prices.[94] However, no appreciable reduction in export prices have been reported by "commission" DISC's.[95]

The DISC legislation was intended to encourage businesses to select the United States, rather than other countries, in which to manufacture.[96] This would permit the Internal Revenue Service to repatriate tax revenues which might otherwise be lost.[97] Notwithstanding this objective, corporations compelled by the nature of their business to manufacture domestically have elected DISC status.[98] This is contrary to the legislative intent and has resulted in the exportation of scarce commodities and the loss of tax revenues to an extent never envisioned.

Prior to the enactment of the DISC provisions, the Treasury Department estimated the loss of tax revenues which might result from this legislation.[99] Using 1972 as a base year, it anticipated revenue losses of approximately $100 million,[100] increasing to

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91. *Id.*

92. A DISC can be operated as a paper corporation, being used primarily as an accounting device for measuring the amount of export earnings subject to tax deferral. *See generally* Proposed Treas. Reg. §§ 1.992-1(a), 1.993-1(*l*)(4), 39 Fed. Reg. 34403 (1974).

93. A "commission DISC" should be less costly to operate because it lacks employees and other general expenses coincidental to the operation of a corporation.

94. ALCHIAN & ALLEN, UNIVERSITY ECONOMICS 227-239 (2d ed. 1967) [hereinafter cited as UNIVERSITY ECONOMICS].

95. *See generally* DISC Report and GAO Report, note 7, *supra.*

96. *See* note 1, *supra.*

97. Since the Internal Revenue Service has not published a non-acquiescence bulletin, it can be assumed that a DISC is an acceptable means for repatriating tax revenues from sales abroad.

98. *See* GAO Report, *supra* note 7, at 2.

99. 120 CONG. REC. E1920 (Daily ed. Mar. 28, 1974) (remarks of the Hon. Charles A. Vanik).

100. *Id.*

$240 million by 1975.[101]

According to the GAO Report, however, the actual 1972 revenue losses amounted to approximately $250 million.[102] Moreover, this report criticizes the Treasury's 1975 projection as being unrealistically low.[103]

The Treasury Department has acquiesced to the GAO Report,[104] and has revised its 1975 revenue loss projection upwards to $740 million.[105] The apparent $500 million discrepancy has been accounted for by increased profit margins in export product lines.[106] Thus the product lines have proven more lucrative than originally anticipated, primarily due to the selection of exported products.[107]

The DISC Report reveals that scarce natural resources and commodities are being exported by DISC's.[108] The DISC's are receiving higher prices for their goods because of increased worldwide demand, and are deferring future tax obligations arising from the transactions.[109] This trend is particularly prevalent in the agricultural, petroleum, chemical, plastic, paper and rubber industries.[110]

Agricultural and chemical products are among the five leading product lines exported and have accounted for almost two-thirds of all DISC activities. Furthermore, forty-two DISC's have reported combined sales of $168.4 million in refined petroleum products and $41.3 million in rubber and plastic goods. Thirty DISC's have reported sales of $240.7 million in paper products.[111]

According to the GAO Report, raw agricultural products and services exported in 1972 aggregated $5.7 billion.[112] Twenty

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101. *Id.*

102. *See* GAO Report, *supra* note 7, at 3; DISC Report, *supra* note 7, at 13.

103. *See* authorities cited in note 102, *supra.*

104. *See* DISC Report, *supra* note 7, at 13.

105. *See* DISC Report, note 7, *supra;* 122 CONG. REC. H4230 (daily ed. May 21, 1974) (remarks of the Hon. Charles A. Vanik).

106. *See* DISC Report, *supra* note 7, at 6, 13, 14; GAO Report, *supra* note 7, at 3. *See especially* Tax Reform Discussions, note 16, *supra.*

107. *See* DISC Report, *supra* note 7, at 6; Tax Reform Discussions, note 16, *supra.*

108. *See* authorities cited in note 107, *supra.*

109. *Id.*

110. Typical examples of these abuses are evidenced when examining the sales records of DISC's which sell scarce products. *Id.*

111. *See* DISC Report, *supra* note 7, at 11.

112. *See* GAO Report, *supra* note 7, at 3.

percent of these sales related to DISC's.[113] Since DISC transactions are not taxable,[114] the Internal Revenue Service lost \$7.5 million in tax revenues.[115]

The GAO Report contains an in-depth analysis of these agricultural transactions, which indicates that fifty-three percent of all DISC transactions dealing in raw agricultural products during 1972 related to grain sales.[116] Specifically, eighteen DISC's were responsible for grain sales amounting to \$600 million.[117] The total industrial figures for that period aggregated \$1.1 billion.[118] Taxable income earned as a result of these grain sales totalled \$5 million.[119] The tax exempt status[120] of DISC's resulted in a loss of \$1.25 million in tax revenues.[121]

It appears that DISC's are exporting scarce domestic products, resulting in the inflation of their prices. By selecting DISC status, the exporter defers any tax obligation that would otherwise be due from the transaction.

Large exporters are the primary beneficiaries of the DISC legislation. Government statistics indicate that eighty-six DISC's with gross receipts between \$10 million and \$100 million earned approximately forty percent of all the deferred DISC income in 1972.[122] Four and one-half percent of all DISC's in operation during that year earned approximately sixty percent of the deferred DISC income. Moreover, in 1972, eight DISC's with gross receipts exceeding \$100 million earned approximately twenty-two percent of all the deferred DISC income.[123]

Was Congress attempting to aid the multi-million dollar corporation which exports scarce domestic products? An examination of the Congressional Record and the United States Code Congressional and Administrative News indicates a contrary conclusion.[124]

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113. *Id.*
114. A DISC is not taxable. *See* text accompanying note 12, *supra.*
115. *See* GAO Report, *supra* note 7, at 3.
116. *Id.*
117. *Id.*
118. *Id.*
119. *Id.*
120. *See* text accompanying note 12, *supra.*
121. *See* GAO Report, *supra* note 7, at 2.
122. *See* DISC Report, *supra* note 7, at 12, 14.
123. *Id.*
124. *See generally* U.S. CODE CONG. & ADM. NEWS, note 1, *supra.*

In enacting the DISC provisions, Congress intended to encourage exporters to manufacture within the United States and export those goods abroad. The legislation offers this encouragement by providing tax incentives to DISC's. Congress planned that both large and small exporters would form DISC's, and because of applicable tax incentives, lower their export prices. Lower prices would benefit consumers and might increase world-wide demand. In order to satisfy this demand, a greater quantity of goods might be produced. If additional goods were produced, more Americans might be employed and exporters' profits might be greater. Congress concluded that if these events occurred, the lagging American economy would improve, thereby stimulating the economies of other nations which trade with the United States.[125]

III. CONCLUSIONS AND PROPOSALS

Unfortunately, the DISC legislation does not appear to have met with the success anticipated by the 92nd Congress. Rather, it has been used primarily to reward DISC's which have exported critically scarce domestic products.[126] Nevertheless, it may be possible to amend the existing DISC legislation to achieve the goals for which it was enacted. In order to rehabilitate this legislation, seven proposals are recommended.

Since the DISC provisions are quite technical,[127] additional treasury regulations and revenue bulletins explaining these rules would be desirable. This should foster a better understanding of these provisions by those who use or plan to use a DISC. In addition, this might decrease the number of DISC's which are suspended because of improper regulatory compliance.[128]

The Treasury Department has permitted the marginal costing rules to be used by some DISC's which would not otherwise qualify for this treatment.[129] This is contrary to the congressional in-

125. *Id.*

126. *See* DISC Report, note 7, *supra*; Considine, *The Disc Legislation: An Evaluation,* 7 N.Y.U.J. INT'L L. & POLITICS 217 (1974) [hereinafter cited as Considine].

127. An example of this technical language is evident in examining the intercompany pricing rules, INT. REV. CODE OF 1954, § 994; Rendell, *Use of a DISC to Reduce Federal Income Tax on Export Earnings,* 11 SAN DIEGO L. REV. 138 (1973).

128. *Id.*

129. *See* note 55, *supra.*

tent,[130] and its widespread use does not appear to have benefited the economy.[131] Therefore, its use should be restricted to those DISC's seeking to establish or maintain a market in export property.

Currently, the 95% *qualified export asset* and *gross receipt* test must be satisfied only at the end of a DISC's taxable year.[132] Thus, throughout the year, *non-qualified* export assets and gross receipts may significantly exceed the 5% maximum[133] without subjecting the corporation to any penalty.[134] Fluctuating ratios seem contrary to the legislative intent.[135] Daily compliance with the 95% test[136] would correct this inconsistency and could be enforced by occasional audits conducted by revenue agents.

There seems to be little justification for classifying a Producer's loan[137] as a *qualified export asset.*[138] This transaction should be subject to the same tax treatment as any other loan made by a domestic corporation to its shareholder. In most cases, this would result in a taxable dividend to the shareholder,[139] rather than a capital asset to the corporation.

As previously noted, a "commission" DISC is legal and serves a desirable function in the business community.[140] Yet its lack of corporate substance and autonomy may be sufficient reasons to consider its abolishment. It would seem easier to manipulate the assets of a "commission" DISC because of its lack of an organic structure.[141] A "buy-sell" DISC, alternatively, is not paid

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130. It was congressional intent that the marginal costing rules should be used only by DISC's seeking to establish or maintain a market in export property. H.R. REP. No. 533, 92d Cong., 1st Sess. 60 (1971); S. REP. No. 437, 92d Cong., 1st Sess. 93, 108 (1971).

131. *See* note 126, *supra.*

132. INT. REV. CODE OF 1954, §§ 992(a)(1)(A), (B).

133. A DISC must maintain, at the conclusion of the taxable year, 95% of its assets invested in *qualified export assets.* Accordingly, only 5% of its assets may be invested in *non-qualified assets.* INT. REV. CODE OF 1954 § 992 (a)(1)(A), (B).

134. This penalty would be the suspension or revocation of a DISC's tax status.

135. If Congress favored the practice of permitting a significant deviation or fluctuation in this 5% rule, it probably would not have enacted this requirement.

136. This test is the *qualified export asset-export receipt* test.

137. For a discussion of Producers' loans, see note 27, *supra.*

138. *Id.*; *accord,* Considine, note 126, *supra.*

139. INT. REV. CODE OF 1954, §§ 301(c), 316, 317; BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS §§ 7-57 (3d ed. 1971).

140. *See* note 20, *supra.*

141. The assets of a "commission" DISC are not necessarily maintained sep-

with trade receivables, and thus is not subject to these same abuses.[142] Although there is no data indicating that a "commission" DISC has been used to distort the financial statements of its related retail supplier, the possibility of such abuse seems quite apparent.[143] In light of these considerations, it would seem advisable to sanction only the "buy-sell" DISC.

The GAO Report indicates that DISC's have been exporting scarce products.[144] Since it seems unlikely that Congress desired to stimulate exportation of scarce goods, DISC tax status should be withdrawn from any corporation exporting such items.[145]

The large exporters seem to be the predominant DISC applicants[146] and do not appear to be lowering export prices.[147] Congress had anticipated that DISC's would lower export prices because of the tax incentives in the legislation.[148] Thus, congressional intent has been partially thwarted.

It may, however, be possible to rehabilitate this legislation to conform to congressional intent. Amendments encouraging a reduction in export prices might achieve this purpose. Two proposals are recommended which may effectuate this goal.

First, a DISC should be required to invest a portion of its retained earnings in modern capital equipment. Assuming this equipment produces greater quantities of scarce goods at lesser costs, such shortages should be reduced both domestically and abroad.[149] In order to manufacture these extra goods, more employees may be needed.[150] Despite added employment costs, exporters' profits should increase from the sale of these additional goods.[151]

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arately and distinctly from those of its related retail supplier. It can be paid in trade receivables. Rendell, *supra* note 20, at 135.

142. *Id.*

143. *See* Tax Reform Discussions, note 16, *supra.*

144. *See* GAO Report, note 7, *supra.*

145. In order to determine whether a product is scarce, a method similar to measuring the Consumer Price Index should be used.

146. *See* DISC Report, note 7, *supra.*

147. *See* DISC Report and GAO Report, note 7, *supra.*

148. U.S. CODE CONG. & ADM. NEWS, 92d Cong., 1st Sess. 1825 (1971).

149. It is a postulate of economics that when supply and demand approach the point of equilibrium, the scarcity of that product is reduced. UNIVERSITY ECONOMICS, *supra* note 94, at 54.

150. If these people are hired, the unemployment rate should decrease.

151. Additional volume usually results in decreasing marginal and average cost per unit. It also results, generally, in higher overall profits. *See* UNIVERSITY ECONOMICS, *supra* note 94, at 229-231.

Second, expenditures for research and development may result in new machinery capable of producing scarce goods inexpensively. To encourage these kinds of expenditures, an incentive program similar to that used by Japan[152] should be considered. Initial deductions for accelerated depreciation would be permitted for appropriate capital investments.[153] Special tax credits would be allowed to encourage the replacement of obsolete equipment.[154] Companies which increase their capital outlay for research and development expenses over the previous year's expenditures would be permitted a tax credit for a percentage of this additional investment.[155] A maximum credit limitation would be provided to prevent this proposal from becoming a tax shelter. Also, this proposal would be subject to constant review, to ensure that this tax credit continues to aid the economy.

If these recommendations are adopted, perhaps the DISC legislation will achieve the purposes for which it was enacted. It would be naive to assume that these recommendations will eliminate all economic problems affecting the United States. Rather, they may provide the needed stimuli to boast the lagging economy. If the American economy improves, the economic condition of other nations which trade with her may likewise benefit.

Dean M. Ward

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152. *See generally* HASKINS & SELLS, INTERNATIONAL TAX AND BUSINESS SERVICE (1972).
153. *Id.*
154. *Id.*
155. *Id.*