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Domestic International Sales Corporations (DISCs): How They provide a Tax Incentive for Exports

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NOTE

DOMESTIC INTERNATIONAL SALES CORPORATIONS (DISCs): HOW THEY PROVIDE A TAX INCENTIVE FOR EXPORTS

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I. INTRODUCTION

Tax law may be the most complex area of the law, since it regulates and permeates an expansive range of relationships, both between one person and another and between each person and the state. International taxation is balanced with yet another layer of complexity because it involves the often conflicting assertion of the states of their right to tax a maximum amount of economic activity. Within this rarified field of international taxation exists an even smaller subset of law which is so internally complex that it makes other tax law topics look like bedtime reading—the law governing Domestic International Sales Corporations, called "DISCs." The bulk of this law is codified in Internal Revenue Code sections 991-997[1] and their interpretive Treasury Regulations.[2] Originally passed in 1971,[3] DISC legislation enabled domestic producers to defer almost indefinitely the tax on a large

1. All references to the Internal Revenue Code (I.R.C.) will be to the Code of 1954, as amended through April 2, 1981, unless otherwise indicated.

2. *See also* Proposed Amendments to Regs. §§ 1.861-3, 1.993-3, 1.993-4, 1.995-4, 1.995-5, 1.996-1, 1.996-3, 46 Fed. Reg. 116-20 (Jan. 2, 1981).

3. Revenue Act of 1971, Pub. L. No. 92-178, §§ 501-507, 85 Stat. 497 (1971)(prior to 1976 amendment).

portion of their export income through a new type of corporate entity, created exclusively for tax purposes.

But why? This Note examines the logical and empirical validity of the reasons for the passage of the DISC legislation. Basically, the DISC legislation was prompted by the negative trade balance in 1971, a novel phenomenon in post-World War II United States.[4] Providing a tax break on producers' export income was viewed as a way of reducing trade deficits by stimulating exports. On its surface, using "tax expenditures" to reach this goal seems logical, or at least benign. But when one considers that the primary thrust of the legislation was to encourage *small* producers to enter the export market,[5] the logic of using a statutory plan that is convoluted at best and baroque at worst is seriously flawed.[6]

After reviewing the legislative history of DISCs, this Note examines the basic mechanics of setting up and operating them. Next, selected aspects of the inner workings of these special cor-

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4. In 1971, . . . there was a trade deficit of $2.7 billion, the first trade deficit incurred by the United States since 1888. This fact was known to Congress when the DISC legislation was passed in December 1971. In 1972, the first year DISC was in effect, exports from the United States made their largest increase ever in dollar terms, rising by over seven billion dollars. Unfortunately, imports increased by over ten billion dollars and the balance of trade widened.

R. FEINSCHREIBER, TAX INCENTIVES FOR U.S. EXPORTS 16 (1975).

5. The desire by small producers to encourage exports was especially evident in the 1976 revisions to the DISC legislation. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1101, 90 Stat. 1520, 1655-60 (1976); *see* Comment, *Evaluating Recent Amendments to Domestic International Sales Corporation Legislation: Has Congress Repaired a Slipped DISC?*, 16 COLUM. J. TRANSNAT'L L. 471, 480, 493 (1977).

6. Bittker and Eustice commented on the provisions' difficulty: "In keeping with the high level of complexity one has come to expect as a matter of course in the foreign tax area, the DISC provisions quickly reach, and rarely leave, a plateau of statutory intricacy seldom rivaled in other sections of the Code." J. BITTKER & S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS & SHAREHOLDERS 17-43 (4th ed. 1979). During hearings on the 1976 revisions, then Senator Muskie remarked:

DISC adds undue complexity to the revenue laws. There is widespread recognition that the tax law has been too complex. DISC is one of the most striking examples of this trend. The statute and long implementing regulations contain numerous complex rules, qualifications, and new concepts that must be carefully adhered to by companies seeking to use DISC. . . .

122 CONG. REC. S13764 (daily ed. Aug. 6, 1976). *See also* BITTKER & EUSTICE, *supra*, at 17-49 ("intricate statutory minuet").

porations will be examined in detail, with particular attention paid to strategies for maximizing DISC benefits. In the final section, policy considerations will be considered in light of a conclusion: Despite the well-intentioned goals of DISC legislation, the DISC concept has been developed in an overly detailed statute, the complex wording of which threatens to obscure the whole purpose of DISCs. That the DISC provisions' marginal impact on reducing trade deficits is so small compared to the compliance maze they create argues strongly for either their immediate repeal or their drastic simplification. While the rules are in effect, however, tax managers of companies with significant income from exports are foolish not to gain tax advantages with DISCs.

II. Legislative History

In the years following World War II, the United States maintained a trade surplus as world trade expanded. Beginning in the 1970's, however, trade deficits began to appear.[7] Congress was aware of the United States' growing trade imbalance when it was hammering out the Revenue Act of 1971,[8] part of a multi-pronged legislative effort to boost United States productivity and exports. The DISC concept, embodied in sections 501-507 of the Act, was a key element in this plan. The House version was "broadly similar" to the Treasury-sponsored Trade Act of 1970,[9] but was a mechanism designed to defer tax not on 100 percent of export income, but only on that export income in excess of a specified base.[10] In conference, the incremental provision was removed, and the plan ultimately provided for the current taxation of fifty percent of a DISC's export-related profit without reference to a base period.[11] There were strong objections that a DISC law without

7. I President's Export Council, The Export Imperative 13, 27 (1980) (graphs at 27-28).

8. Pub. L. No. 97-178, 85 Stat. 497 (1971); *see* H.R. Rep. No. 533, 92d Cong., 1st Sess. 4, *reprinted in* [1971] U.S. Code Cong. & Ad. News 1825, 1828. For an edited version of the 1971 House, Senate, and House Conference Reports containing only those portions pertaining to DISCs, see Feinschreiber, *supra* note 4, at 157-247.

9. The Trade Act (H.R. 18970) was passed by the House but not by the Senate. *See* H.R. Rep. No. 533, *supra* note 8, at 8, U.S. Code Cong. & Ad. News at 1832.

10. *Id.*

11. Conf. Rep. No. 708 at 20, *reprinted in* [1971] U.S. Code Cong. & Ad. News 2053, 2072.

this type of incremental provision "had every likelihood of rewarding the large corporations presently engaged in exporting without increasing our exports or helping small businesses to increase exports."[12] The Conference version became law.[13]

DISCs were not the first attempt by Congress at granting tax preferences to encourage export-related income. The precursors of DISCs were the Western Hemisphere Trade Corporations (WHTC),[14] which were designed to increase exports in the Western Hemisphere through a tax rate reduction (called a "deduction" under former I.R.C. section 922).[15]

The unfavorable United States balance of payments and trade deficits in 1970 and 1971 were not the only reasons behind the passage of the DISC legislation. In addition, the DISC concept was promoted as equalizing two inequities faced by exporting domestic manufacturers. The first perceived inequality was that domestic manufacturers were disadvantaged *vis-a-vis* other United States companies which produced and sold goods abroad through

12. H.R. REP. No. 533, *supra* note 8, at 91, [1971] U.S. CODE CONG. & AD. NEWS 1915 (dissenting views of Rep. Gibbons). For a discussion of the equities of DISC law as originally passed, see Considine, *The DISC Legislation: An Evaluation,* 7 N.Y.U.J. INT'L L. & POL. 217, 219-22 (1974).

13. Pub. L. No. 92-178, §§ 501-507, 85 Stat. 497 (1971). In an unusual move, the Treasury issued a "DISC Handbook" in 1972, which apparently was to be used for guidance in operating DISCs until regulations could be promulgated. Announcement 72-73, 1972-1 C.B. 24, *reprinted in* W. GIFFORD & W. STRENG, INTERNATIONAL TAX PLANNING 34-56 (1979). It discusses the pre-1976 DISC legislation in remarkably clear prose compared with the regulations on DISCs which ultimately came out.

14. Formerly in I.R.C. §§ 921-922, and before that, §§ 109, 119 of the Internal Revenue Code of 1939. WHTCs were repealed by the Tax Reform Act of 1976, and 1979 was the last possible tax year in which a company might receive WHTC benefits. Because the first possible DISC tax year was 1972, the two types of corporations existed side by side for eight years. There is extensive literature, now outdated, comparing the tax benefits of the two. *See* FEINSCHREIBER, *supra* note 4, at 66-70; Feinschreiber, *DISC versus WHTC—A Quantitative Comparison,* 2 INT'L TAX J. 80 (1975); Llewellyn & Lewis, *Foreign Sales Income: Tax Planning & Selection of the Corporate Structure,* 7 RUT.-CAM. L.J. 228 (1976).

15. An exemption would have been an outright violation of the General Agreement of Tariffs & Trade (GATT). Report of the GATT Working Party on Subsidies of Nov. 19, 1960 (BISD, 9th Supp., Geneva, 1961). For the same reason, DISC tax sections allow deferral, not exemption. *See* Considine, *supra* note 12, at 225. *See also* Mills, *DISC: Response to Trade-Distorting Border Tax Adjustment under GATT,* 31 TAX EXECUTIVE 135 (1979).

foreign subsidiaries, thus allowing them to defer tax on their foreign earnings on funds kept abroad.[16] The second inequality was created by other major trading countries that effectively punish imports and reward exports at their borders through value added taxes.[17]

Despite the need to reduce inequities in foreign tax law, and despite the unprecedented eight billion dollar trade deficit confronting the United States in 1976,[18] Congress succumbed to the pressure of the "tax preference" critics and gutted the deferral mechanism in the DISC legislation by enacting an "incremental rule" similar to the one originally amended out of the House version of the 1971 Act.[19] The main effect of the incremental rules (aside from an exponential increase in the complexity of the DISC operation) was to reward only *increases* in export sales and not export sales for which "no incentive is needed."[20]

President Carter adamantly opposed DISCs as a corporate loophole and tried to have the DISC Code sections repealed in 1978.[21] Congress resisted repeal, and the provisions have not changed since the 1976 amendments.[22] Meanwhile, the number of DISCs continues to climb—12,192 as of February 1980, an eleven percent increase over the number in February 1979.[23] The Reagan administration has not publicly indicated its position on DISCs. It is difficult to predict whether the current Administration's gen-

16. H.R. REP. No. 533, *supra* note 8, at 58, [1971] U.S. CODE CONG. & AD. NEWS 1872.

17. *Id.*

18. I EXPORT IMPERATIVE, *supra* note 7, at 27.

19. For a discussion of the operation of the incremental rule, see text accompanying notes 43-45 *infra;* Table D *infra.* For the official "explanation of the provisions" of the incremental rule, see Joint Committee Staff, General Explanation of the Tax Reform Act of 1976 at 291-300 (1976), *reprinted in* Gordon, 264-3d T.M., *Domestic International Sales Corporations (DISC)* at B-201 to B-207 (1978). It is a fine example of what semanticists call "dead-level abstraction." *See* S. HAYAKAWA, LANGUAGE IN THOUGHT & ACTION 161-64 (3d ed. 1972).

20. H.R. REP. No. 658, 94th Cong., 2d Sess. 264, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3159; *id.* at 433, U.S. CODE CONG. & AD. NEWS 3326 (supplemental views of Rep. Rostenkowski).

21. U.S. TREASURY DEP'T, CARTER ADMINISTRATION'S PROPOSAL FOR TERMINATING DISC 274-76 (1978), *reprinted in* S. THOMPSON, JR., FEDERAL INCOME TAXATION OF DOMESTIC & FOREIGN BUSINESS TRANSACTIONS at 588-89 (1980).

22. *See* Nauheim & Cass, *U.S. Tax Proposals, 1978—The End of Deferral & DISC?,* 78-3 TAX MGM'T INT'L J. 3, 14 (1978).

23. Green, *Planning DISC Operations in the '80's,* 6 INT'L TAX J. 373, 374 (1980).

eral pro-business attitude means DISCs will be maintained and even strengthened, or whether the Administration's desire to slash red tape means that DISCs will get the ax.[24] Reagan's first round of proposed tax cuts left DISCs unscathed.[25]

III. Basic Structure and Operation

This section explains the initial and ongoing requirements of DISCs, illustrated by a hypothetical DISC operation. It is important to remember while wading through the requirements that a DISC, like a Subchapter S corporation, is basically a conduit through which non-deferred income flows back to the shareholders as either actual or constructive dividends, to be taxed at the shareholder level. The DISC itself is exempt from all taxes, except the section 1491 tax on transfers to avoid income tax.[26] The main structural requirements of a DISC are contained in I.R.C. section 992:

(1) A DISC must be incorporated in one of the fifty states or the District of Columbia. It cannot be a tax-exempt organization, a personal holding company, a bank or savings and loan, an insurance company, a mutual fund, a China Trade Act corporation, or a Subchapter S corporation.
(2) A DISC needs only $2500 in equity capital, which may be represented by only one class of shares.
(3) The shareholders (typically, one parent corporation) must unanimously elect DISC status for the first taxable year. Unlike the Subchapter S corporation election, the DISC election need be made only once. Consent of later shareholders is unnecessary.
(4) The adjusted basis of all "qualified export assets"[27] must

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24. *See* note 6 *supra*.
25. *See* [1981] 10 Stand. Fed. Tax Rep. (CCH) ¶ 6155 (President Reagan's tax cut proposals).
26. I.R.C. § 991.
27. Defined in I.R.C. § 993(b) to include:
(1) "export property" (itself defined in § 993(c); *see* note 31 *infra*);
(2) assets used primarily in connection with the sale, lease, rental, storage, handling, transportation, packaging, assembly, or servicing of export property;
(3) accounts receivable from producers;
(4) working capital;
(5) producer's loans (*see* note 67 *infra*);
(6) stock in a related FISC (*see* note 69 *infra*); and

equal at least ninety-five percent of total assets.
(5) The DISC must have records separate from its parent's (though the same computer system can generate both sets) and its own bank account on each day of the taxable year. This provision is necessary to the enforcement of DISC tax law because the corporation itself exists largely on paper.[28]

Although these rules are relatively straightforward, the slightest deviation (such as not having a separate bank account on the last day of a taxable year) can lead to disqualification; there is a "safe harbor" means of complying with the ninety-five percent assets test, however, that can save a "disqualified" DISC if the owners are able to comply within eight and one-half months after the end of the DISC's taxable year even if there is no good faith reason for initially failing the test.[29]

The three most salient operational requirements for DISCs are the ninety-five percent gross receipts test, the allocation of income between parent and DISC, and the taxation of shareholders on "deemed distributions." Each taxable year, at least ninety-five percent of gross receipts must be "qualified export receipts," one of many terms of art created by the DISC legislation,[30] which are receipts resulting from the sale or lease of "export property."[31]

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(7) miscellaneous Eximbank obligations.

28. *See* S. REP. No. 437, 92d Cong., 1st Sess. 91 (1971), *reprinted in* [1971] U.S. CODE CONG. & AD. NEWS 2069.

29. I.R.C. § 992(c)(3).

30. I.R.C. § 993(a).

31. I.R.C. § 993(c). Briefly, "export property" includes property:
(a) manufactured, produced, grown, or extracted in the United States by a non-DISC person;
(b) held in the ordinary course of business primarily for sale, rental, or lease by (or to) a DISC for direct use, consumption, or disposition abroad; and
(c) not more than 50% of the fair market value of which is attributable to imports.
Not surprisingly, this definition has been the subject of much litigation and many Revenue Rulings. *See* GIFFORD & STRENG, *supra* note 13, at 59-67. One of the most important yardsticks for "manufacturing" is the "20% rule" found in Treas. Reg. § 1.993-3(c)(2)(iv), T.D. 7514 (1977), and enunciated in Rev. Rul. 75-429, 1975-2 C.B. 312: "Property is manufactured . . . by a person for the purposes of § 993(c) . . . if with respect to such property conversion costs (direct labor . . . including packaging or assembly) of such person account for 20 percent or more of the cost of goods sold. . . ." Therefore, DISCs can add up to 20% in value to the goods without destroying their character as "export property."

Qualified export receipts also include interest on "producer loans,"[32] which are loans from a DISC to a producer for producing export property. The two ninety-five percent rules virtually guarantee that a DISC will be a shell corporation created expressly for tax purposes, as it is unlikely that an ongoing corporation would intentionally meet these requirements. Because section 482 establishes arm's length attribution rules with which parent and subsidiary corporation doing international business must comply, the allocation of income between producers and their DISCs is one of the more remarkable provisions of the legislation, because it provides the only two safe harbors from the arm's length attribution rules.[33] The two safe harbor rules are known as the "four percent rule" and the "fifty-fifty rule."[34] These rules allow producers to allocate to the DISC the higher of (a) four percent of qualified export gross receipts or (b) fifty percent of the combined taxable export income of the DISC and parent. If the DISC works on a commission basis, as opposed to serving as an intermediary which actually buys and resells the products, the percentages are based on the producer's export gross receipts or taxable export income.[35] No losses may be allocated by DISCs to their parents,[36] although transactions may be grouped annually by product, by product line, or even by transaction to maximize the benefits of any one safe haven rule.[37] Finally, no matter what safe haven transfer pricing method is used, ten percent of all "export promotion expenses"[38] are added to the DISC's taxable income.[39]

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32. I.R.C. § 993(d); *see* note 67 *infra.*

33. Allocation via § 482 *may* be used, however, if it provides the DISC with more profit than either of the safe haven rules. I.R.C. § 994(a)(3); see Treas. Reg. § 1.994-1(a) for the scope of intercompany pricing rules.

34. I.R.C. §§ 994(a)(1), 994 (a)(2).

35. *See* Treas. Reg. § 1.994-1, T.D. 7435 (1976).

36. *Id.* § 1.994-1(e)(1).

37. *Id.* § 1.994-1(c)(7); *see* Feinschreiber, *Maximizing DISC Profits Through Quantitative Pricing Techniques,* 2 INT'L TAX J. 28 (1975); text accompanying notes 59-60 *infra.*

38. I.R.C. § 994(c). Here we find a good example of gratuitous regulation permeating DISC legislation: export promotion expenses include one-half of freight costs, but only if by sea or by air, and then only if shipped on United States ships or airplanes, and *then* only if such shipping is *not* required by law or regulations. On using export promotion expenses to boost the amount of profit allocated to DISCs, see Feinschreiber, *Increasing DISC Benefits Through Export Promotion Expenses,* 3 INT'L TAX J. 371 (1977); Feinschreiber, *supra* note 37, at 28-31.

The teeth of the DISC deferral plan is the concept of constructive ("deemed") distribution. Because this provision ultimately determines how much tax a DISC's shareholders pay, it has received more legislative attention than the other sections. The "incremental" revisions of 1976 took place here. (It is important to remember throughout the following discussion that a DISC receives at most fifty percent of the export income from a producer's operations. Therefore, even before the incremental rule, when a DISC was deemed to distribute fifty percent of *its* income back to the producer, the DISC and producer as a unit were able to defer tax on *at most* twenty-five percent of total export income. So, when percentages of DISC income are discussed, they represent only half the income of the producer and DISC as an economic unit.) For various policy reasons, there are eight types of "deemed distributions" from a DISC to its shareholders each taxable year:[40]

(1) gross interest on producer's loans;
(2) gain on sale or exchange property other than "qualified export property";
(3) gain on sale or exchange of any property with recapture potential;
(4) one-half the taxable income from the sale of military property;
(5) taxable income attributable to "base period export gross receipts" (another term of art; non-incremental part of incremental rule; does not apply to "small" DISCs);[41]
(6) one-half the excess taxable income (before actual distributions) over the five categories above *plus* 100 percent of any boycott income under I.R.C. section 999 and any bribes or illegal payments;
(7) the dollar amount of foreign investments made with producer's loans from DISCs (note that this comes *after* all normal distributions—it is meant to discourage foreign investment by cutting directly into deferred income); and

39. I.R.C. §§ 994(a)(1), 994(a)(2). Section 994(b) also contains a provision for marginal costing, which is beyond the scope of this Note. The interested reader is referred to Treas. Reg. § 1.994-2.

40. This discussion is borrowed largely from [1981] 6 STAND. FED. TAX REP. (CCH) ¶ 4399R.03.

41. See discussion in incremental rule at text accompanying notes 43-45 *infra*; Table D *infra*.

(8) revocation distributions or distributions to meet the ninety-five percent assets or income tests (these distributions are extraordinary and normally would not be made each year).[42]

Though a working knowledge of the "incremental rule" is not essential to an understanding of this Note, the distributions described in (5) and (6) above demand a little more explanation:

> A DISC's taxable income for the current year is . . . in effect divided into two parts: one part, the nonincremental part, is equal to taxable income attributable to adjusted [base period] export gross receipts . . .; and the other part, the incremental part, is the excess of the current year's taxable income over the taxable income attributable to export gross receipts in the base period. The nonincremental part of the current year's taxable income is treated as a deemed distribution from the DISC to its shareholders and is taxed currently to them. . . . As to the remaining taxable income—the incremental part, one half is also deemed distributed and taxed currently to the shareholders, while tax on the other half is deferred.[43]

"Adjusted base period export gross receipts" is another new term of art. It means sixty-seven percent of the average DISC's export gross receipts for the four taxable years of the base period.[44] And because the base period is set up as the fourth, fifth, sixth, and seventh taxable years before any current taxable year,[45] the DISC is effectively put on a "treadmill": it must continually export more than sixty-seven percent of the moving base period average to get *any* deferred tax.[46]

To bring these rules down to a more concrete level, they can be applied to the hypothetical Calcutron corporation.

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42. An odd (and punitive) quirk in this remedial distribution is that, if the 95% *assets* test (not income test) is not met at the end of the taxable year, the fair market value of *all* "bad" assets, not just 95%, must be distributed. *See DISC: A Panel Discussion Sponsored by the [ABA] Section of Taxation—Midwinter Meeting—Colorado Springs, Jan. 28, 1973,* 26 TAX LAW. 537, 559 (1973).

43. Gourevitch, *DISC's Ability to Defer Tax on Income Restricted by Tax Reform Act of 1976,* 46 J. TAXATION 9, 9 (1977).

44. I.R.C. § 995(e)(3).

45. I.R.C. § 995(e)(5)(b).

46. *See* Comment, *supra* note 5, at 480.

Calcutron Facts

Calcutron, Inc., a California corporation located in "Silicon Valley," uses electronic chips in producing two types of hand-held calculators: (1) Minicalc, a small, cheap, four-function model; and (2) Maxicalc, a larger, expensive, scientific calculator. Although Calcutron sells equal dollar amounts of the two models, the profit margins are four percent and sixteen percent respectively, stronger competition for the Minicalc having kept prices low. Calcutron manufactures the mechanical and electronic components, but imports the molded bodies and zippered vinyl pouches from Taiwan. The bodies and pouches make up only twenty percent of the fair market value of the calculators. Calcutron also adds ten percent in value in preparing the calculators for shipment. Although not required to do so by law, the company ships its exported calculators only on United States carriers as a matter of principle, even though they charge somewhat more than foreign carriers. Calcutron exports twenty-five percent of its calculators to Canada and twenty-five percent to Western Europe. It maintains sales offices in leased space in Toronto and Munich, each staffed by three salespeople.

DISCutron Facts

Calcutron, on advice of astute but slow-moving tax counsel, formed a wholly-owned DISC named DISCutron, Inc. in 1973. Calcutron complied with the basic formalities: $2,500 minimum capitalization, separate bank accounts, one class of stock, and proper election.[47] Calcutron assigned DISCutron half its shipping operations and the Montreal and Munich assets, which now constitute part of DISCutron's qualified export assets. DISCutron can prepare the calculators for shipment without disqualifying as a "manufacturing" operation because it adds less than twenty percent to the fair market value of the calculators.[48] Similarly, the calculators qualify as "export property" even though they incorporate some imported parts, because the percentage of fair market value attributable to imports is only twenty percent, less than the fifty percent allowed under I.R.C. section 993(c)(1)(C).[49] In computing its export promotion expense, DISCutron can include

47. *See* text accompanying notes 26-28 *supra*.
48. Rev. Rul. 75-420, 1975-2 C.B. 312; *see* note 31 *supra*.
49. *See* note 31 *supra*.

not only the costs of the sales forces in Montreal and Munich, but also half the shipping expenses (because they comply with the rules of I.R.C. section 994(c)).[50]

DISCutron's 1973 Tax Deferral

Based on the above information, DISCutron's deferral for 1973 would be computed as follows:

TABLE A: DISCUTRON'S 1973 PROFIT AND DEFERRED INCOME WITH MUNICALC AND MAXICALC GROUPED TOGETHER

(Data in 000's)

DISCutron Export Gross Receipts (EGR)		$4,000
Less: DISCutron's Export Expenses	300	
Less: Calcutron's Cost of Goods Sold	2,500	
Less: Calcutron's Apportioned Expenses	800	
Total Deductions		3,600
DISCutron Combined Taxable Income (CTI)		$ 400
DISCutron's Profit under the 50% CTI Method		200
DISCutron's Profit under the 4% EGR Method		160
Maximum DISC Profit		200
Add: 10% Export Expenses		30
Total DISCutron Profit		$ 230
(this implies an intercompany price of $3,700 between Calcutron and DISCutron.)		
Amount Deferrable (50% of Total DISCutron Profit)		$ 115

Mathematically, the "four percent rule" for safe haven intercompany pricing yields higher DISC profit than the "fifty-fifty rule" only when the DISC combined taxable income is less than eight percent of the DISC export gross receipts.[51] Because Calcutron's average profit margin is ten percent, the "fifty-fifty rule"

50. *See* note 38 *supra*.

51. For example, if a producer has $100 in EGR and the total cost of production is $94, that leaves $6 in CTI; it also represents a 6% profit margin. The "50-50 rule" would allow only 50% of CTI, or $3 in deferred income, but the "4% rule" would allow 4% of $100, or $4. If costs of production decrease to $90, that leaves $10 in CTI and represents a 10% profit margin. The "50-50 rule" would yield $5 in deferred income, but the "4% rule" would yield only $4.

yields the higher DISC profit of the two safe haven rules—here, $200,000 v. $160,000. Using $200,000 as the DISC profit, the addition of the $30,000 in export expenses yields $115,000 in deferrable income.

Because Calcutron's two product lines have widely varying profitability—Minicalc at four percent and Maxicalc at sixteen percent—more profit may be squeezed into DISCutron by segregating the two product lines and choosing the more advantageous safe haven rule for each one before adding in ten percent of export promotion expenses:

TABLE B: DISCUTRON'S 1973 PROFIT AND DEFERRED INCOME WITH MINICALC AND MAXICALC SEGREGATED

(Data in 000's)

	MINICALC		MAXICALC	
DISCutron EGR		$2,000		$2,000
Less: DISC Export Expenses	150		150	
Less: Calcutron Cost of Goods Sold	1,370		1,130	
Less: Calcutron Overhead	400		400	
Total Deductions		1,920		1,680
DISCutron CTI		$ 80		$ 320
DISCutron Profit—50% CTI Method		40		160
DISCutron Profit—4% EGR Method		80		80
Maximum DISC Profit				$ 240
($80 from Minicalc and $160 from Maxicalc)				
ADD: 10% Export Expenses (Total)				30
Total DISCutron Profit				$ 270

Segregating the two product lines caused the maximum DISC profit to jump to $240,000. After export expenses of ten percent were added into total DISC profit, DISCutron had $135,000 in deferrable income. This represents an increase of seventeen percent from the income deferrable without segregation.

Table C below shows the hypothetical financial history of Calcutron and DISCutron (1973-1981) based on the following assumptions:

(1) Calcutron's gross receipts were $8,000,000 in 1973.

(2) Total gross receipts grow at $1,000,000 per year (note that this implies a slower *percentage* growth each year,

TABLE C: CALCUTRON'S DISC HISTORY, 1973-1981 (Dollar Figures in OOO's)

YEAR	CALCUTRON TXBL INC	DISCUTRON CTI	MAX DISC PROFIT (6% EGR)	ADD 10% EXPORT EXPENSE	TOTAL DISC INCOME	ABPEGR*	DEEMED DISTRIBUTIONS: INCRMNTL RULE	DEEMED DISTRIBUTIONS: 50% OF REMAINDER	DEFERRED INCOME: TOTAL	DEFERRED INCOME: % OF TOTAL DISC INCOME	DEFERRED INCOME: % OF CALCUTRON TXBL INC.
1973	800	400	240	30	270	-0-	-0-	135	135	50%	17%
1974	900	450	270	34	304	-0-	-0-	152	152	50%	17%
1975	1,000	500	300	38	338	-0-	-0-	169	169	50%	17%
1976	1,100	550	330	41	371	2,261	153	109	109	29%	10%
1977	1,200	600	360	45	405	2,261	153	126	126	31%	11%
1978	1,300	650	390	49	439	2,261	153	143	143	33%	11%
1979	1,400	700	420	53	473	2,261	153	160	160	34%	11%
1980	1,500	750	450	56	506	3,183	215	146	146	29%	10%
1981	1,600	800	480	60	540	3,518	237	151	151	28%	9%
									1,291		

*Adjusted Base Period Export Gross Receipts which is realistic for the years under consideration).

(3) DISCutron's gross receipts are always fifty percent of Calcutron's—that is, Calcutron derives half its gross receipts from exports.

(4) Calcutron's taxable income is always ten percent of its gross receipts, and DISCutron's "combined taxable income" is always ten percent of its export gross receipts. Its two products, Minicalc and Maxicalc, sell in equal dollar amounts yielding profits of four and sixteen percent respectively.

(5) Because it segregates transactions by product, DISCutron's maximum profit using the four percent method for Minicalc and the fifty-fifty method for Maxicalc is constant at six percent of DISCutron's export gross receipts.

(6) Export promotion (selling) expense is constant at seven and one-half percent of DISCutron's export gross receipts.

(7) For 1976-1979, the "base period" for computing the deemed distribution from non-incremental sales is 1972-1975 (I.R.C. section 995(e)(5)(A)); for 1980, the base period is 1973-1976, and for 1981, the base period is 1974-1977 (I.R.C. section 995(e)(5)(B)).

(8) DISCutron was formed January 1, 1973, and remained qualified (that is, it passed the ninety-five percent assets and gross receipts tests) every year through 1981.

The 1976 data can be used to show how the "incremental rule," added by the Tax Reform Act of 1976, operates. The "base period" for DISC tax years 1976-1979 is made up of the years 1972-1975.[52] Because DISCutron was not formed until 1973, it had $0 in export gross receipts for 1972. DISCutron's "base period export gross receipts" are therefore smaller than they would have been had DISCutron been formed in 1972. The base is reduced even further by a quirk in the statutory "adjustment" to base period gross receipts—receipts for the period are divided by four, and not simply averaged for the years in which the DISC *had* export gross receipts.[53] Here is the 1976 deferral computation:

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52. I.R.C. § 995(e)(5)(A).
53. I.R.C. § 995(e)(6).

TABLE D: CALCULATING CALCUTRON'S 1976 INCOME DEFERRED WHEN INCREMENTAL RULE IS IN EFFECT

(Data in 000's)

A. BACKGROUND DATA

Calcutron Gross Receipts		$11,000
Calcutron Taxation Income		1,000
DISCutron EGR:	1972	0
	1973	4,000
	1974	4,500
	1975	5,000
	1976	5,500
DISCutron 1976 CTI		550
Maximum DISC Profit, Segregating Maxicalc and Minicalc		330
10% Export Promotion Expenses		41
Total DISCutron 1976 Income		371

B. COMPUTING ABPEGR

Adjusted Base Period Export Gross Receipts (ABPEGR)
= 67% x (EGR for 1976, 1973, 1974, and 1975) / 4
= 67% x (0 + 4,000 + 4,500 + 5,000) / 4
= 2,261

C. COMPUTING DISTRIBUTION FROM INCREMENTAL RULE

Deemed Distribution for *Non-Incremental* EGR

$$= \text{Total DISC Profit} \times \frac{\text{ABPEGR}}{\text{1976 EGR}}$$

$$= 371 \times \frac{2{,}261}{5{,}500}$$

= <u>153</u>

D. REGULAR DEEMED DISTRIBUTION

50% Deemed Distribution from *Incremental* EGR
= 50% x (Total DISC Profit—Deemed Distribution from Non-Incremental EGR)
= 50% x (371-153)
= <u>109</u>

E. DEFERRED INCOME

Total DISCutron Profit		371
Less: Distribution, Non-Incremental	153	
Less: Distribution, 50% Incremental	109	262
Deferred Income*		109

*(The income itself is not deferred; the tax on it (46%, or $50) is deferred.)

F. DEFERRED INCOME AS PERCENTAGES

Deferred Income as % of 1976 DISCutron Total Incomed	29%
Deferred Income as % of 1976 Calcutron Taxable Income	10%

Had the "incremental rule" not been in effect, Calcutron's 1976 deferred income would have been $186,000. The actual deferral of $109,000 represents a forty-one percent decrease. As the last column in Table C shows, deferred income as a percent of Calcutron taxable income dropped from seventeen percent in 1975 to ten percent in 1976. During 1977-1979, the percentage inched up slightly to eleven percent, but declined again in 1980-1981 once the base period started to include later taxable years.

The preceding examples described how a DISC is started and operated. But what happens when a DISC is terminated or disqualifies? This is another aspect of a DISC that resembles a Subchapter S corporation. The DISC maintains three accounts: "accumulated DISC income," the undistributed, tax deferred income; "previously taxed income," the undistributed income already deemed distributed and taxed to shareholders; and "other earnings and profits," accumulated in years when the corporation was not a DISC.[54] If a DISC election is revoked or terminated automatically (which happens if the DISC fails to qualify in each of five consecutive tax years), any actual distributions come first out of "previously taxed income" tax-free. "Accumulated DISC income" is not taxed to shareholders all at once, but is deemed distributed in equal amounts over the shorter of ten years or twice the number of years the DISC had qualified.[55] DISCutron qualified for at least five years, so if it disqualified after 1981, its "accumulated DISC income" of $1,291,000 would be taxed to Calcutron at $129,100 per year for ten years.

DISC stock is not likely to be traded freely, but it can be disposed of through sale or at death of the shareholder. If DISC stock is sold at a gain, the shareholder is immediately taxed at ordinary rates on his share of DISC income accumulated during the time that shareholder held the stock.[56] The transferee may still have his "accumulated DISC income" spread out, however. Through a quirk in estate tax sections, no gain or loss is recog-

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54. BITTKER & EUSTICE, *supra* note 6, at 17-49; *see* [1981] 6 STAND. FED. TAX REP. (CCH) ¶ 4339R.01.

55. I.R.C. § 995(b)(2)(B). Before the 1976 amendments, the "distributions upon disqualification" were spread out over the lesser of ten years or the number (not twice the number) of "immediately preceding consecutive taxable years during which the corporation was a DISC." This aspect of DISC distributions gives rise to an important planning strategy. *See* text accompanying note 66 *infra*.

56. I.R.C. § 995(c)(2).

nized when DISC (or former DISC) stock is transferred by reason of the shareholder's death. Although the effect on DISC stock of the I.R.C. section 1023 carryover rules is unclear,[57] the transferee may also get a stepped-up basis. This has obvious estate planning advantages for individual DISC shareholders.

I.R.C. section 995(c), which controls recapture of DISC income on disposition of DISC stock, covers treatment of gain in two situations: sale at a gain and disposition on DISC termination. In each case, gain is treated as dividend income to the extent of the shareholder's pro rata share of "accumulated DISC income." Astute authors have pointed out[58] that, unlike I.R.C. section 1245, I.R.C. section 995(c) does not override the provisions of section 337 and 302. Such strategies leading to *permanent* deferral of tax on "accumulated DISC income" present intriguing possibilities, but are beyond the scope of this Note. Most of the avoidance is made possible by the fact that a DISC shareholder is not responsible for "accumulated DISC income" accumulated when he was not holding the stock.

IV. Selected Provisions Presenting Strategic Advantages

Whether or not the DISC provisions do what they set out to do, they are likely to be with us for at least a few more years, and any phase out would probably occur over a span of years rather than months. It is therefore important to note some special aspects of the DISC rules that present the tax planner with hidden but substantial opportunities for maximizing benefits, despite the retrenchment of the incremental rule. Because some of these aspects require extensive mathematical proofs, these descriptions are cited to sources that provide detailed explanations and calculations.

Judicious grouping of the transactions before applying the safe haven intercompany transfer pricing rules is the first technique by which more profits can be squeezed into DISCs, thereby increasing deferred taxes.[59] Though the possibilities for increasing profit through segregation and grouping are far more complex than the DISCutron example, the segregation of DISCutron's two product lines, shown above in Table B, provides a simple example

57. Gordon, *supra* note 19, at A-38.

58. Fisher, Kohl, & Knox IV, *With Proper Planning, Deferred Ordinary Income of a DISC Need Never Be Recaptured,* 40 J. Taxation 138 (1974).

59. The best source on this topic is Feinscreiber, *supra* note 37.

of this technique. Mathematically, profit allotted to a DISC reaches a local maximum at four percent; therefore, products, product lines, or transactions should be grouped so that their profit margins are neither more nor less than four percent.[60]

It is obvious from the way the safe harbor rules are set up that export promotion expenses can be a source of extra DISC income. The rules here are unusually picky, however, and should be followed to the letter.[61]

Several elements of the incremental rule present profit maximizing opportunities. The first is the "small DISC" exception,[62] which eliminates the deemed distribution based on adjusted base period export gross receipts for DISCs with less than $100,000 in adjusted taxable export income, and phases it in on a two-for-one basis for DISCs with adjusted taxable income from $100,000 to $150,000. There may therefore be cases when DISC income should be intentionally limited to $100,000, especially for large but unprofitable or declining DISCs.[63] Producers with "accumulated DISC income" greater than $150,000 should not, however, form multiple DISCs in the hope of spreading the income among them and exempting them from the incremental rule. The Internal Revenue Service has already thought of this, and I.R.C. section 995(e)(10) provides for the combining of tax attributes of brother-sister DISCs.[64]

A second silk purse can be made from the incremental rule's ears because of the seven years it takes for a new DISC to develop a full four-year base period. A DISC has no base period export gross receipts until its fifth taxable year, and then any base pe-

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60. Feinschreiber classifies transactions by profit margin: Class A if greater than or equal to 8% (use 50-50 method if ungrouped); Class B if greater than 4% but less than 8% (use 4% method if ungrouped); Class C if less than 4% but still profitable (use 4% method subject to no loss rule if ungrouped); and Class D if unprofitable (exclude from DISC unless grouped with other transactions or priced under § 482). *Id.* at 34-35. He then generates examples to develop strategies for grouping classes of transactions to maximize DISC income. *Id.* at 37-55.

61. *See* Feinschreiber, *supra* note 38.

62. I.R.C. § 995(f).

63. *See* R. FEINSCHREIBER, INTERNATIONAL TAX PLANNING TODAY 118-25 (1977).

64. For a thorough discussion of the three anti-avoidance rules in I.R.C. § 995(e)(8)-(10), see Gourevitch, *supra* note 43, at 10-11. *See also* General Explanation of the Tax Reform Act of 1976, *supra* note 19, at B-203 to B-205 in Gordon.

riod total is divided by four (rather than arithmetically averaged) before the sixty-seven percent rule is applied. So if a DISC grows even moderately over its first eight years, the incremental rule will have less than its full effect. For DISCutron, the first year in which there was a four-year base period was 1980. In that year, "adjusted base period export gross receipts" jumped forty-one percent, and deferrable income dropped nine percent, even though export gross receipts had increased $500,000 (see Table C). Of course, this puts new *or* growing DISCs at an advantage over older, stagnating ones.[65] For example, if Calcutron's export sales had remained flat at $4,000,000 for the years 1973-1981, DISCutron could have deferred only $767,000 in income over that time—less than sixty percent of the $1,291,000 it was able to defer with sales growing at decreasing rates.

A final strategic benefit linked to the incremental rule is gained from the long span of time over which "accumulated DISC income" trickles in after disqualification of the DISC. For example, if a DISC disqualifies in year six, deemed distributions are spread equally over years seven to sixteen. This means that a producer not only should try to qualify its DISC for at least five years to get the maximum benefit of the rule, but should also consider establishing a nominal DISC at the same time it begins its main one. Then, should the main DISC disqualify, assets could be transferred to the nominal DISC to keep the clock running to deferral purposes.[66]

Miscellaneous strategic planning possibilities exist apart from the transfer pricing and incremental rules. One is the use of a "commission" DISC rather than a "buy-sell" DISC, which actually takes title to all goods exported. A commission DISC offers several savings: no employees are required, fewer records are required, and customers need never know the DISC exists. In addition, if the DISC buys its accounts receivable, rather than taking loans from the producer, producers acquire the DISC's tax-deferred money in a more profitable manner. Producer's loans are so restricted that the red tape may not be worth the effort,[67] and

65. *See* Comment, *supra* note 5, at 482; Henning & Kretzer, *DISC & the '76 Act*, 9 TAX ADVISER 324, 329 (1978).

66. *See* FEINSCHREIBER, *supra* note 62, at 157-59.

67. Treas. Reg. § 1.993-4 contains the Byzantine rules controlling producer's loans. Basically, a "producer's loan" is a loan by a DISC out of its "accumulated DISC income" to a producer (not necessarily its parent). It must be evidenced

having the DISC buy accounts receivable avoids the complexity of the "wash" transaction that interest payments generate.[68] Yet another trick is to defer tax on deemed distributions an extra eleven months by having the DISC's taxable year end one month after its parent's taxable year. Finally, a DISC with a need for a foreign sales office can make use of a *Foreign* International Sales Corporation (FISC) to augment its income and increase its deferral, particularly if the FISC is located in a tax haven country.[69]

V. Policy Considerations

In the introduction, it was suggested that trade deficits were the main reason for DISC legislation. Despite the one-dimensionality of this view, it is sometimes cited as a sufficient reason.[70] Actually, many other economic factors were considered,[71] though most were related to the United States balance of trade and balance of payments deficits.[72] There was also concern about the exporting of jobs,[73] but the main concern was with relative tax inequities. Before DISC, domestic exporters faced five tax disadvantages:

> (1) United States tax was deferred on foreign subsidiaries' income, but not on income from foreign sales by domestic corporations;
> (2) GATT and the value-added tax structure in other countries allowed them to tax imports but exempt exports, dis-

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by a note with an appropriate legend; it may not have a maturity of more than five years; it may not be used for foreign investment (if it is, the portion invested becomes a deemed distribution; *see* text accompanying notes 42 *supra*). In fact, it can be used only to expand the producer's export assets for research and development. *See* Norman, *The Use of Producer's Loans to Increase DISC Benefits*, 1 Int'l Tax J. 201 (1975).

68. *DISC: A Panel Discussion*, *supra* note 42, at 549.

69. I.R.C. § 993(e). A discussion of FISCs is beyond the scope of this Note. For more information, see Feinschreiber, *supra* note 62, at 138-42; Feinschreiber, *FISC: The Foreign International Sales Corporation*, 1 Int'l Tax J. 214 (1975); Feinschreiber, *How to Double DISC Benefits Through FISC & Grouping*, 6 Int'l Tax J. 367 (1980).

70. *See* E. Owens & G. Ball, The Indirect Credit 374 n.1 (1975); 1 R. Rhoades, Income Taxation of Foreign Related Transactions § 4.41[1] (1973).

71. *See generally* S. Rep. No. 437, 92d Cong., 1st Sess. (1971), *reprinted in* [1971] U.S. Code Cong. & Ad. News 1978.

72. Feinschreiber, *supra* note 4, at 14.

73. *DISC: A Panel Discussion*, *supra* note 42, at 538.

> advantaging foreign exports;
> (3) foreign states promoted their domestic exports through accelerated depreciation and large write-offs for export promotion expenses;
> (4) foreign states were more lenient than the United States in allowing exporters to retain profits in tax haven countries through relaxed intercompany pricing; and
> (5) the limited tax haven devices under United States law mainly benefitted large corporations, putting smaller exporters at a competitive disadvantage.[74]

Whether or not the legislators who passed the 1971 and 1976 tax acts were aware of each of these inequities, the DISC legislation as it evolved has responded in part to each of them.

But this begs the question. Given the United States' balance of payments problems, is a change in tax policy the most effective or equitable way to "correct" the imbalance? As with most economic phenomena, opinions on this issue vary. If a majority of the members of Congress from 1971 to the present did not perceive the DISC program as being either effective or equitable, it would not have lasted. But commentators are split.[75] Not surprisingly, Robert Feinschreiber, the most published expert on DISCs,[76] thinks they have been a benefit.[77] President Carter's Export Council even recommended strengthening DISCs.[78] But the econometric data remain inconclusive, and another commentator, William Considine, has cast serious doubt on both the premises and the

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74. Considine, *supra* note 12, at 218-19. *See also* J. BISCHEL & R. FEINSCHREIBER, FUNDAMENTALS OF INTERNATIONAL TAXATION 108-09 (1977).

75. Some sources provide only qualified praise. *See* Comment, *supra* note 5, at 494 ("The 1976 reforms appear to have made the DISC more efficient, more effective, and more equitable. . . . [T]he 1976 amendments are sufficiently well-conceived to justify cautious optimism regarding [DISC's] continuing utility.").

76. At last count, Feinschreiber has published nineteen articles and three books discussing DISCs. For a partial bibliography, see FEINSCHREIBER, *supra* note 62, at 377-79.

77. *See* FEINSCHREIBER, *supra* note 4, at 16: "In 1972, the first year DISC was in effect, exports from the United States made their largest increase ever in dollar terms, . . ." *Cf.* Considine, *supra* note 12, at 222 ("Exports were not the weak part of our payments balance. Domestic exports rose 40% from 1967 to 1971." (Footnote omitted)).

78. I PRESIDENT'S EXPORT COUNCIL, *supra* note 7, at 98-99 ("DISC provides working capital to exporters to finance the longer-term accounts receivable that are usual with customers in foreign countries, and DISC also provides funds to encourage risky long-term market development in new foreign growth areas.").

results of the DISC provisions.[79] Considine was not the first to question the basic premise of using tax law to effect this particular economic end,[80] but his main points are so cogent that they bear listing:

(1) It is fallacious to expect DISCs to increase domestic employment, because employment is more a factor of monetary and fiscal policy. A tax expenditure is therefore no better than other possible expenditures.
(2) To correct a balance of payments deficit, the classical solution is to devalue the currency. Although the President's reluctance to do so may have been a boost to DISC's passage, the dollar was devalued by more than seventeen percent anyway, only eight days after the DISC legislation passed. It is statistically impossible to attribute the surge in exports in 1972 to DISC operations alone for this very reason.[81]
(3) DISC creates its own inequity, favoring those producers which export over those which sell domestically.
(4) Small business is less likely to use a complex procedure because the paperwork may be too expensive relative to its benefits for a small enterprise.[82]
(5) Most large exporters decide to export or invest abroad largely for non-tax reasons. Therefore, they will treat the DISC legislation as a windfall, not as an incentive.
(6) DISCs save only one percent of export receipts on average (from tax deferral). If costs equal ninety percent of receipts, then even a three percent difference in costs would swamp any DISC benefits.
(7) DISC helps those who have and hurts those who have

79. Considine, *supra* note 12.

80. *See* REPORT OF THE PRESIDENT'S TASK FORCE ON BUSINESS TAXATION 43 (1970); *Hearings on the Trade Act of 1970 Before the House Committee on Ways & Means,* 91st Cong., 2d Sess. 2611 (1970); *Hearings on the Revenue Act of 1971 Before the Senate Committee on Finance,* 92d Cong., 1st Sess. 631, 720, 724, 741 (1971).

81. *See* note 75 *supra.*

82. Considine also cites an economic study showing the remarkable resistance small producers exhibited to exporting even with massive personal assistance and information. Piper, *How U.S. Firms Evaluate Foreign Investment Opportunities,* 19 MICH. ST. U. BUS. TOPICS 11 (1971). And with the legal and accounting costs of setting up a DISC ranging from $2,500 to $15,000 *in 1972,* small businesses would be even less interested. BUS. WEEK, July 29, 1972, at 30.

> not.[83] And the same firms which get more than half of export receipts account for eighty percent of United States investments abroad—so any inequity between foreign subsidiaries and domestic subsidiaries which export is illusory.[84]

Surprisingly, Considine appears to be the only commentator to have used both pure and applied economics to evaluate the DISC provisions. His damning findings, when compared with the more usual vague allusions to efficiency and equity based on gross numerical data, convincingly argue that DISC probably never has done what it set out to do—increase exports and employment while reducing perceived tax inequities.

The DISC provisions could hardly be more convoluted. Even accepting the premise that international income tax law is bound to be more complex than domestic income tax law, the basic operation of Domestic International Sales Corporations is well beyond the grasp of the small exporter the statute was purportedly designed to benefit. With the incremental rule in full effect, a small exporter can defer tax on only ten percent of its taxable income (see the last columns of Table C, above). With marginal corporate tax rates at forty-six percent, the small exporter can use or invest about four and one-half percent more than it would normally be able to invest, and part if not all of these savings are eaten up by the ongoing legal and accounting fees related to DISC operations. Though the savings can still be significant for big exports, the small exporter is probably better off looking for ways to cut costs, raise profit margins, or hedge on future swings in dollar valuations in the commodities markets than to attempt to use DISCs.

If export promotion is a goal, DISC legislation is not the optimal use of tax law to achieve this goal. The fear of "windfalls to current exporters that led to the diabolical "incremental rule" implies that some exports are better than others. If this is true, the incremental rule should be amended once again, so that one hundred percent, and not just sixty-seven percent, of base period export receipts are used to increase deemed distributions, and

83. In the Seventh Annual Report on DISCs issued by the Treasury in 1980 (for tax years ending between July 1977 and July 1978), the 31 largest DISCs, less than .3% of the total number, generated more than half the total DISC income. Green, *supra* note 23, at 376.

84. These points were distilled form the whole of Considine's article. Footnotes supporting his claims have been omitted. Considine, *supra* note 12.

deferral is limited to income generated by truly incremental sales. A more direct deemed distribution rule would require a DISC to subtract last year's receipts from this year's receipts, and then distribute fifty percent of the remainder.

Simplification of the DISC provisions so that small exporters comprehend and are motivated by such provisions risks more "windfalls" to current exporters. If Congress is not willing to face that risk and make the DISC program more accessible, it should pull the plug on DISC, let the deferred income seep back into the tax base, and focus on non-tax measures that would increase exports, such as spending cuts, budget balancing, or regulatory reform.

In the meantime, many more corporations could be taking advantage of DISCs. The sluggish domestic economy is forcing more and more companies to look across United States borders at foreign markets. Forming DISCs to funnel foreign sales can reduce the costs of penetrating new markets. What DISCs provide is the benefit of time: income ultimately comes home to roost (and to be taxed), but during the deferral period, producers can use money that would otherwise be taxed away. With short-term interest rates recently peaking at over twenty percent, the time value of income deferral has increased dramatically. For example, if DIS-Cutron's $1,291,000 in deferred income goes back to Calcutron over ten years, Calcutron could earn $2,370,000 in interest at twenty percent.

DISCs' high incorporation and operational expenses militate for the formation of one DISC by several small exporters. A commission DISC would work best in this context because it would require less paperwork than a buy-sell DISC. Shareholders would then get DISC benefits proportionate to their interests. Alternatively, a small exporter might be able to buy shares in an older, established DISC that may have declining sales and problems meeting its assets tests.

Though DISC provisions are unarguably complex, the tax benefits they provide are undeniably substantial. Tax managers in exporting corporations of whatever size need to be made aware of the benefits so that they can evaluate whether the marginal benefits of DISC exceed its marginal costs.

Garrison R. Cox