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The Disc Provisions: Tax Incentive to Increase Exports

William J. Chadwick

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I. Introduction

The Domestic International Sales Corporation (hereinafter DISC) provisions of the Revenue Act of 1971[1] create a new type of corporate entity entitled to special tax treatment on export-related income. In general, the DISC, like the Subchapter S corporation, is not subject to United States federal income tax at the corporate level.[2] The DISC's shareholders are taxed as currently receiving

1. Act of December 10, 1971, Pub. L. No. 92-178, Title V, 85 Stat. 497, *amending* INT. REV. CODE of 1954 §§ 246, 861, 901, 904, 922, 931, 971, 1014, 1504, 6011, 6072, 6501; *adding* §§ 991-97, 6686 [hereinafter cited as INT. REV. CODE]. The Treasury first submitted the DISC proposal to the House Ways and Means Committee on May 12, 1970. The House passed the proposal as Title IV of the Trade Act of 1970 on August 21, 1970. H.R. 18970, 91st Cong., 2d Sess. (1970). The legislation was not approved by the Senate, however, and consequently the DISC provisions were not enacted in 1970. Secretary of the Treasury Connally resubmitted the DISC proposal to the House Ways and Means Committee on September 8, 1971. *Hearings on H.R. 10947 Before the House Ways and Means Comm.*, 92d Cong., 1st Sess. (1971). It was approved by the House of Representatives in essentially the same form as the 1970 version with one major change: the benefits of DISC were made available to taxpayers only on an incremental basis. H.R. REP. No. 92-533, 92d Cong., 1st Sess. (1971). Under the House bill, deferral of export related profits was available only to the extent the profits of the DISC were attributable to exports of the controlled group in excess of 75 per cent of the average exports of that group for the 1968-1970 base period. *Id.* The change was made in response to the argument that the DISC alternative represented a windfall to those companies already exporting, which companies would receive DISC deferral even to the extent they were maintaining their prior level of exports. Rothkopf, *Qualifying Under the New Export Income Laws: Advantages and Hazards,* 8 J. TAX 134 (1972) [hereinafter cited as Rothkopf]. The Senate Finance Committee's version, however, provided for deferral of 50 per cent of the DISC's export related income. S. REP. No. 92-708, 92d Cong., 1st Sess. 91 (1971). The Conference Committee agreed with this approach, which was alternately enacted into the law. H. REP. No. 92-708, 92d Cong., 1st Sess. (1971). Since the Senate and House Reports are virtually identical concerning DISC, references will be to the Senate Report [hereinafter cited as S. REP.]. It is important to note that section 506 of the Act states that the Secretary of the Treasury shall submit an annual report to the Congress setting forth an analysis of the operation and effect of the DISC provisions. The intent of this section may be to make the DISC provisions temporary. *See* S. REP. at 129.

2. *Compare* INT. REV. CODE § 991 *with* § 1372 (b).

one-half of the DISC's profits, whether or not actually distributed.[3] The remaining one-half of the DISC's earnings may be retained tax-free by the DISC.[4] This tax-deferred income may be used by the DISC to extend financing to its foreign customers, to increase its inventory of products for exportation, to invest in office and warehouse facilities used in its business, to pay its suppliers more promptly or to invest in certain Eximbank obligations.[5] More importantly, the DISC may use its tax-deferred income in order to make "producers loans."[6] In other words, the tax on one-half of the DISC's earnings is deferred indefinitely, provided it is used for export development. For example, if the DISC has $50,000 of export income, $25,000 is taxed currently to its shareholders as a dividend and $25,000 is eligible for deferral.[7] Deferral terminates, and the tax is imposed on the shareholders of the DISC, if the deferred income is distributed, the shareholder sells his stock or the corporation no longer qualifies as a DISC.[8] As long as the corporation remains in existence, however, this deferred income is deemed taxable to the shareholders in equal installments over a ten year period, or such shorter period as the DISC was in existence.[9]

The DISC may serve as a principal by purchasing and reselling export property.[10] Additionally, it may serve as an agent receiving

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3. S. REP., *supra* note 1, at 91; *see* INT. REV. CODE § 995.

4. S. REP., *supra* note 1, at 92. The Accounting Principles Board of the American Institute of Certified Public Accountants has determined that the deferred federal income taxes on the earnings of a DISC can be treated in the same way as the deferred taxes of a foreign subsidiary. This means that such taxes need not be taken into account for financial statement purposes provided there is no intention to distribute the income or otherwise act so as to end the deferral of tax liability. U.S. TREASURY DEP'T, DISC: A HANDBOOK FOR EXPORTERS 8 (1972) (this booklet is the first official Treasury interpretation of what a DISC is, and how to set up and qualify as a DISC) [hereinafter cited as HANDBOOK]. The Treasury Department is now drafting the DISC regulations which will probably not be published in final form until the third quarter of 1972.

5. HANDBOOK, *supra* note 4, at 2.

6. *See* INT. REV. CODE § 993(d) (definition of a producer's loan). See discussion of this technical term at pp. 481-83 *infra*.

7. Inasmuch as the deferral is of indefinite duration it may have the same practical effect as an exemption. See the more comprehensive example at pp. 474-76 *infra*.

8. S. REP., *supra* note 1, at 92; *see* INT. REV. CODE § 995.

9. INT. REV. CODE § 995(b)(2)(B). See the more detailed discussion of taxation on termination of DISC status at p. 472 *infra*.

10. HANDBOOK, *supra* note 4, at 12.

commissions on export sales.[11] In either case, special intercompany pricing rules[12] allow the DISC to earn greater profits than would be permissible under the traditional "arms length" standard.[13] The DISC also may handle exports produced by any number of related or unrelated producers.[14] It may lease or sublease United States produced property, or serve as an agent for such transactions.[15] Furthermore, the DISC may perform services incidental to any sale or lease transaction.[16] Similarly, the DISC may perform engineering or architectural services for foreign construction projects or manage other DISC's.[17] The DISC may not, however, sell or lease property produced by it.[18]

The new Code provisions provide a substantial reward for corporations engaged in exporting. Moreover, these corporations can perform a wide range of activities without forfeiting their favored treatment. The new statutory scheme, however, is not designed to promote tax simplification. New tax terms and concepts coupled with detailed and complicated rules may deter many corporations from securing the substantial tax benefits available. The purpose of this note, therefore, is to analyze the intricate new DISC provisions with emphasis on the qualification requirements and other major operative provisions.

11. HANDBOOK, *supra* note 4, at 12.

12. See discussion of these new rules at pp. 480-81 *infra*.

13. INT. REV. CODE § 482; TREAS. REG. 1.482-1 (generally the prices and charges made to related parties must be essentially the same as those made to unrelated parties, *i.e.*, the "arm's length" standard). See note 178 at p. 480 *infra*, for further discussion of the § 482 rules.

14. HANDBOOK *supra* note 4, at 12.

15. *Id.* For example, several producers could arrange to export through a jointly owned DISC, thereby offering a complete product line. *Id.* at 5.

16. HANDBOOK, *supra* note 4, at 12.

17. HANDBOOK, *supra* note 4, at 7.

18. *Id.*

II. Qualification Requirements

A. *In General*

A DISC is a corporation,[19] organized under the laws of any state or the District of Columbia,[20] that elects pursuant to a unanimous vote of its shareholders to be treated as a DISC.[21] The DISC must have at least $2,500 of equity capital which is limited to one class of stock.[22] It must have at least 95 per cent of its receipts in the form of qualified export receipts[23] and have at least 95 per cent of its assets in the form of qualified export assets.[24] The determination of whether a corporation satisfies these statutory requirements is to be made annually.[25] Certain domestic corporations, however, are specifically excluded: organizations that are tax exempt under section 501, personal holding companies, banks, savings and loan associations and similar financial institutions, insurance companies, mutual funds, China Trade Act corporations, and Subchapter S corporations.[26] In addition, Western Hemisphere Trade Corporations and Possessions Corporations cannot attain DISC status without forfeiting their already favored tax treatment.[27] Furthermore, an association taxable as a corporation cannot qualify for DISC treatment.[28]

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19. In cases where an export business in conducted in a non-corporate form, by a sole proprietorship or a partnership, it must organize as a corporation. HANDBOOK, *supra* note 4, at 2. The incorporation of a business may be accomplished tax-free. INT. REV. CODE § 351. Furthermore, incorporation as a DISC will not result in "double taxation," since the corporation itself is tax-exempt. *See* INT. REV. CODE § 991.

20. A corporation organized under the laws of a possession cannot qualify as a DISC. *See* INT. REV. CODE § 992(a)(1).

21. INT. REV. CODE § 992(a)(1)(D).

22. INT. REV. CODE § 992(a)(1)(C).

23. INT. REV. CODE § 992(a)(1)(A).

24. INT. REV. CODE § 992(a)(1)(B).

25. INT. REV. CODE § 992(a)(1) (with respect to any taxable year).

26. INT. REV. CODE § 992(d)(1)-(7). However, in the case of a DISC engaged in renting films abroad, there are situations in which the corporation might be treated as a personal holding company, even though the parent from which it acquired the films would not be so treated if it received the rents directly. The new law has a provision designed to prevent this from occurring. INT. REV. CODE § 992(e). *See generally* S. REP., *supra* note 2, at 97.

27. INT. REV. CODE §§ 922, 931(a). An interesting question is whether a WHTC should shift its status to become a DISC. *See generally* Rothkopf, *supra* note 1, at 138.

28. S. REP., *supra* note 1, at 92. A Webb-Pomerene Association which is

B. *The DISC Election*

The corporation must make a valid election to be treated as a DISC, and the election must be in effect for the entire taxable year.[29] The election must be filed with both the Internal Revenue Service office in which the corporation would file its income tax return if it were subject to normal taxation,[30] and with the Commissioner of Internal Revenue.[31] A newly formed corporation must make the election on or before the 90th day after the beginning of its first taxable year.[32] In the case of other corporations, the election must be made within the 90 day period before the beginning of the first taxable year in which it seeks to qualify as a DISC.[33] The Commissioner, however, is authorized to accept elections made at other times.[34] In addition, all persons who are shareholders on the first day of the first taxable year for which the election is effective must consent to DISC treatment within 90 days after the first day of the first taxable year for which such election applies.[35] In the case of a foreign shareholder, the consent represents an agreement by the shareholder that any distribution of gain or other income to the shareholder is effectively connected with the conduct of a trade or business in the United States through a permanent establishment.[36] Unlike a Subchapter S election, a valid DISC election binds succeeding shareholders even though they originally did not consent to the election.[37] The initial election continues in effect for subsequent

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organized as a corporation may readily qualify as a DISC. HANDBOOK, *supra* note 4, at 5.

29. INT. REV. CODE § 992(b).

The following discussion is based on an interpretation of the amended Internal Revenue Code and a recent Revenue Ruling. The Revenue Ruling applies *only* for 1972; presumably, however, the procedure in subsequent years will be similar.

30. REV. PROC. 72-12, § 3.01 (Also released as *Technical Information Release 1124,* dated December 17, 1971).

31. REV. PROC. 72-12, § 3.01.

32. REV. PROC. 72-12, § 3.02.

33. REV. PROC. 72-12, § 3.02.

34. INT. REV. CODE § 992(b)(1)(A).

35. REV. PROC. 72-12, § 4.02.

36. HANDBOOK, *supra* note 4, at 11. *See also* INT. REV. CODE §§ 871(b), 882 (distributions to foreign shareholders are subject to the regular U.S. tax rates).

37. *Compare* INT. REV. CODE § 992(b)(2) *with* § 1372(e)(1) (new Subchapter S shareholders must consent to the corporate election or the election is terminated).

years, unless it is revoked by the shareholders or terminated by the I.R.S.[38] In short, unlike a tax-option corporation, a DISC election cannot be terminated inadvertently.[39] A DISC election may be revoked for any taxable year except the first.[40] To take effect for a particular year, the revocation must be filed within the first 90 days of that year,[41] and if a revocation is filed after the 90 day period, it will take effect for the following year.[42] If an electing corporation does not qualify as a DISC for five consecutive years, it will be disqualified automatically for the sixth and succeeding taxable years.[43] Although an election is revoked or terminated, the corporation is not precluded from making another DISC election in the following year.[44]

C. *Corporate Substance*

On each day of its taxable year the corporation must have at least $2,500 of equity capital.[45] The capital requirement is intentionally low so that a corporation may qualify even though it has a small amount of capital.[46] The Senate Report states that "this rule constitutes a relaxation of the general rules of corporate substance."[47] This proposition is perhaps dubious since capitalization would be only one of several factors to be taken into account in determining whether a subsidiary corporation is merely a "dummy" whose existence may be ignored.[48] Notwithstanding the "dummy" corporation question, the Senate intended that a DISC be recognized as a separate entity.[49]

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38. INT. REV. CODE § 992(b).
39. *Compare* INT. REV. CODE § 992(b) *with* § 1372.
40. INT. REV. CODE § 992(b)(3)(A).
41. INT. REV. CODE § 992(b)(3)(A)(i).
42. INT. REV. CODE § 992(b)(3)(A)(ii).
43. INT. REV. CODE § 992(b)(3)(B).
44. *Compare* INT. REV. CODE § 992(b) *with* § 1372(b).
45. INT. REV. CODE § 992(a)(1)(C).
46. S. REP., *supra* note 1, at 92.
47. *Id.*
48. *See* National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949).
49. S. REP., *supra* note 1, at 92. It is important to note the distinction between tax and non-tax cases in relation to corporate substance. In at least one non-tax case the court relied only on corporate capital in deciding whether the corporate entity should be disregarded. *See* Arnold v. Phillips, 117 F.2d 497 (5th Cir.), *cert. denied*, 313 U.S. 583 (1941). The Senate is attempting to establish the validity of the DISC entity notwithstanding state law requirements.

Like the Subchapter S corporation, the DISC may have only one class of stock.[50] This requirement is included to avoid the complexities that would otherwise arise when certain income is deemed distributed.[51] Debt of a DISC, however, will not be reclassified as stock.[52] Consequently, a DISC is immunized from the debt-equity problem confronting the Subchapter S corporation. Similarly, in contrast to the Subchapter S corporation, "[i]ndividuals, corporations, partnerships, trusts and estates, including nonresident aliens and foreign corporations can own DISC stock."[53] Western Hemisphere Trade Corporations and Possessions Corporations, however, cannot be DISC shareholders.[54] These two special corporations are excluded to insure that they do not receive a double tax benefit.[55] There are no limitations or requirements on the number of shareholders a DISC may have. Neither the statute nor its legislative history addresses the nature of the activities that a DISC must conduct to qualify. Revenue Ruling 72-166, however, provides that a DISC must have its own bank account and separate books and records.[56] Although the Treasury Department's recently published Handbook on DISC tax provisions encourages the DISC to have its own employees, a recent Revenue Ruling provides illustrations in which the DISC, a wholly-owned subsidiary, has no employees on its payroll and yet is a separate entity which qualifies as a DISC.[57] Consequently, in order to satisfy the requirements of the Internal Revenue Service, a DISC need be little more than a bookkeeping operation.

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50. *Compare* INT. REV. CODE § 992(a)(1)(C) *with* § 1371(a)(4).

51. S. REP., *supra* note 1, at 93.

52. HANDBOOK, *supra* note 4, at 10. The Handbook further indicates, however, that wide disparities in funds made available by different groups of stockholders do not justify treatment of stock as equity. *Id.*

53. *Id.* A Subchapter S corporation cannot have as a shareholder a person (other than an estate) who is not an individual. INT. REV. CODE § 1731(a)(2). In addition, non-resident aliens cannot be Subchapter S shareholders. INT. REV. CODE § 1372(a)(3).

54. INT. REV. CODE §§ 922, 931(a).

55. S. REP., *supra* note 1, at 125.

56. REV. RUL. 72-166 (also released as *Technical Information Release 1152,* dated March 16, 1972).

57. REV. RUL. 72-166.

D. *Gross Receipts Test*

To qualify as a DISC, at least 95 per cent of the corporation's "gross receipts"[58] must consist of receipts which are considered export related.[59] The statutory scheme provides eight categories of qualified receipts:

(1) receipts from the sale of export property;
(2) receipts from the leasing or subleasing of export property;
(3) receipts from services in connection with a qualified export sale or lease transaction;
(4) gains from the sale of qualified export assets;
(5) foreign investment dividends;
(6) export related interest;
(7) receipts from engineering or architectural services; and,
(8) receipts derived from management services.[60]

In general, export property consists of tangible products made predominately in the United States which are then exported.[61] The first category in the statutory scheme includes receipts from the sale of inventory and other property produced, manufactured, grown or extracted in the United States which is sold for "direct use, consumption or disposition outside the United States."[62] However, a sale of property to an American manufacturer for incorporation in a product to be exported would not be considered as an export sale.[63] Secondly, qualified export receipts include receipts from the leasing of property to be used by the lessee outside the United States.[64] Since the "usage test" is to be determined on a year-by-year basis,[65] the receipts from an export property lease might qualify in some years and not in others. For example, if the property is used predominately within the United States in a particular year, the receipts would be

58. "Gross receipts means the total receipts from the sale or lease of inventory qualifying as export property and gross income from all other sources. In the case of commissions [gross receipts equals] the amount of gross receipts received by the principal from the sale or lease . . . on which the commissions were paid." HANDBOOK, *supra* note 4, at 13.
59. S. REP., *supra* note 1, at 97.
60. INT. REV. CODE § 993(a).
61. See discussion of "export property" at p. 469 *supra.*
62. INT. REV. CODE § 993(c)(1)(A)-(B).
63. S. REP., *supra* note 1, at 97.
64. HANDBOOK, *supra* note 4, at 13.
65. S. REP., *supra* note 1, at 97.

disqualified.[66] *De minimus* use of the property within the United States, however, will not affect qualification.[67] Thirdly, receipts from services are qualified receipts. These receipts include commission receipts that are "related and subsidiary" to any qualified sale or lease, regardless of the place the services are performed.[68] Neither the statute, its legislative history, nor the Handbook defines "related and subsidiary" in detail. Presumably, however, receipts derived from services rendered in installing and maintaining equipment sold to a foreign customer by the DISC would qualify.[69] On the other hand, if the services had a value greater than the property sold, the receipts would not qualify.[70] Fourthly, gain realized on the sale of the DISC's plant, equipment or other assets used in the DISC's export business is a qualified receipt.[71] Fifthly, dividends from certain qualified foreign investments, which are export related, qualify as export related receipts.[72] Generally, the investment will be in the stock or securities of a foreign selling subsidiary of the DISC that qualifies as a foreign international sales corporation.[73] However, stock or securities of a controlled foreign real estate title company and of an unrelated foreign corporation also qualify.[74] Sixthly, interest on qualified export assets[75] is a qualified receipt.[76] For example, interest on accounts receivable arising from sales in which the DISC acted as principal or agent, interest on producer's loans, and interest on certain Eximbank or Foreign Credit Insurance Association obligations may qualify.[77] Seventhly, receipts from engineering or architectural services on construction projects that are located abroad or are expected to be located outside the United States are qualified export receipts, regardless of where the services are performed.[78] Furthermore, such services are considered qualified receipts, whether or not rendered in connection with the sale of export property by the DISC

66. HANDBOOK, *supra* note 4, at 16, 17.
67. S. REP., *supra* note 1, at 97.
68. HANDBOOK, *supra* note 4, at 13, 14.
69. HANDBOOK, *supra* note 4, at 14.
70. *Id.* Companies, such as those selling computer hardware and software, are likely to request rulings in this area.
71. *Id.*
72. *Id.*
73. HANDBOOK, *supra* note 4, at 24.
74. HANDBOOK, *supra* note 4, at 14.
75. See discussion of "qualified export assets" at pp. 469-71 *infra.*
76. INT. REV. CODE § 993(a)(1)(F).
77. HANDBOOK, *supra* note 4, at 14.
78. *Id.*

or any other United States person.[79] Examples of qualified services include feasibility studies, design and engineering, and general supervision of construction.[80] Receipts from the actual performance of construction work, however, are excluded.[81] Similarly excluded are receipts derived from the provision of technical assistance or know-how in relation to the exploration for minerals,[82] especially oil.[83] Finally, receipts for management services are qualified and allow a DISC to manage, staff and operate related or other DISC's.[84]

In order to limit the application of the deferred tax treatment to situations which, in fact, involve export transactions, the statute excludes five types of transactions from qualified export receipts.[85] First, receipts arising from the sale or leasing of property for ultimate use by itself, or as a component of another article, in the United States are excluded.[86] The Senate Finance Committee's interpretation of this test proscribes use of the product as a component in the manufacture of an item in the United States if that item is subsequently exported.[87] Another example of a non-qualified receipt is the sale of a product to a foreign wholesaler when it is known that the wholesaler supplies the United States retail market to a substantial extent.[88] Secondly, receipts from the sale of agricultural products under the P.L. 480 program and other United States Government programs designed to subsidize exports are excluded.[89] Thirdly, those receipts are excluded which result from a situation in which property is sold or leased to the United States Government if it is required by law to purchase United States property.[90] The receipts qualify, however, if the government purchases the property for resale to others on commercial terms.[91] Fourthly, receipts are excluded if they are from another member of the same group of "controlled"[92] corpora-

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79. *See* HANDBOOK, *supra* note 4, at 14.
80. S. REP., *supra* note 1, at 98.
81. HANDBOOK, *supra* note 4, at 14.
82. *Id.* at 14.
83. S. REP., *supra* note 1, at 98.
84. *Id.*
85. *Id.*
86. *Id. See* INT. REV. CODE § 993(a)(2)(A).
87. S. REP., *supra* note 1, at 98.
88. HANDBOOK, *supra* note 4, at 15.
89. S. REP., *supra* note 1, at 98.
90. S. REP., *supra* note 1, at 99.
91. HANDBOOK, *supra* note 4, at 17.
92. The term "controlled group" has the meaning assigned by § 1563(a), except that the phrase "more than 50%" is substituted for the phrase "at least 80%." Furthermore, § 1563(b) does not apply. INT. REV. CODE § 993(a)(3).

tions as the recipient corporation, and the company involved is a DISC.[93] Finally, excluded receipts include receipts from services provided in connection with any sale or lease which is itself excluded by any of the above categories.[94]

E. *Assets Test*

The DISC must have qualified assets with an adjusted basis equal to at least 95 per cent of the sum of the adjusted basis of all its assets in order to satisfy the "assets test."[95] Section 993(b) provides nine categories of qualified export assets:

(1) export property;
(2) assets used primarily in connection with the sale, lease, rental, storage, handling, transportation, packaging, assembly or servicing of export property or the performance of services producing qualified export receipts;
(3) accounts receivable and other debt obligations arising from qualified export receipts;
(4) liquid assets which represent reasonable working capital requirements;
(5) obligations arising out of producer's loans;
(6) stock or securities of a foreign international sales corporation or other related foreign export corporation;
(7) obligations issued, guaranteed or insured by the Eximbank or the Foreign Credit Insurance Association;
(8) obligations of a domestic corporation organized solely to finance export sales; and,
(9) United States bank deposits beyond reasonable working capital needs that are utilized in a subsequent period to acquire other qualified export assets.[96]

As previously indicated, export property, as defined by the statute, is property manufactured, produced, grown or extracted in the United States which is held for sale or lease in the ordinary course of business

93. S. REP., *supra* note 1, at 99.

94. *Id.*

95. INT. REV. CODE § 992(a)(1)(B). Neither the statute nor the Handbook indicates whether different depreciation methods may be used for qualified and non-qualified assets. This omission may allow the taxpayer to use the depreciation rules to great advantage.

96. INT. REV. CODE § 993(b)(1)-(9).

for direct use or consumption outside the United States.[97] In addition, not more than 50 per cent of the fair market value of the property can be attributable to imported products.[98] The Senate Report states that if a DISC performs assembly or packaging operations in connection with the property it sells, the facilities used for this purpose will constitute qualified export assets.[99] The facilities will not be so qualified, however, if the operations constitute manufacturing.[100] Generally, if the property is substantially transformed by the DISC prior to sale, the property is treated as manufactured by the DISC.[101] Furthermore, operations performed by the DISC will be considered to constitute the manufacture, production or construction of property if the value added to the product sold by reason of the operations of the DISC accounts for 20 per cent or more of the total cost of goods sold.[102] The legislation specifically excludes property which is leased by the DISC for ultimate use by any other member of its controlled group;[103] intangible property such as patents, inventions, copyrights, trade names and formulas;[104] and property designated by the President as in "short supply."[105] The so-called "destination test" generally will be considered satisfied if the DISC delivers the property to a carrier or freight forwarder for delivery outside the United States.[106] Similarly, the DISC may sell the property to an unrelated person for delivery outside the United States.[107] Alternatively, the DISC may sell the property to an unrelated person in the United States, provided the DISC establishes that after the sale there is no further sale, use, assembly or other processing within the United States and that the property is delivered outside the United States within one year of the sale.[108] For purposes of the "50 per cent test," any foreign component imported into the United States and incorporated into the

97. INT. REV. CODE § 993(c)(1)(A)-(B).
98. INT. REV. CODE § 993(c)(1)(C).
99. S. REP., *supra* note 1, at 100.
100. *Id.*
101. *Id.*
102. *Id.*
103. INT. REV. CODE § 993(c)(2)(A).
104. INT. REV. CODE § 993(c)(2)(B).
105. INT. REV. CODE § 993(c)(3). To date no property has been declared in "short supply" for this purpose.
106. HANDBOOK, *supra* note 4, at 15.
107. *Id.*
108. *Id.*

product must be valued at its full fair market value at the time of importation.[109] The customs invoice is expected to be the basis on which the value of imported goods will be ascertained, and it is further expected that certificates from manufacturers will be given to the DISC listing any foreign component in the product.[110]

III. Taxation of a DISC and its Shareholders

A. *Corporate Tax*

The DISC is exempt from the basic corporate income tax, the minimum tax on tax preference items and the accumulated earnings tax.[111] On the other hand, the DISC is subject to withholding, social security and excise taxes.[112] Since a personal holding company cannot qualify as a DISC, the legislation does not relieve the company from the personal holding company tax.[113] The DISC must file an annual information return,[114] however, and failure to file such a return will result in a $1,000 penalty.[115]

B. *Shareholder Tax*

While the DISC itself generally is not subject to taxation, the shareholders of the DISC will at some time be taxed fully on corporate earnings and profits. That point will be no later than the time of distribution, although it may be earlier. Actual distributions are treated like those of any other corporation. The dividend income of the shareholders is limited to the corporation's current and accumulated earnings and profits.[116] Similarly, a DISC shareholder is taxed on actually distributed corporate receipts that were not taxable income to the corporation. In addition, the provisions of section

109. S. Rep., *supra* note 1, at 101.
110. *Id.*
111. S. Rep., *supra* note 1, at 92.
112. The latter includes the 27½% excise on the appreciation element in stock or securities transferred to a foreign corporation as paid in surplus or as a contribution to capital.
113. S. Rep., *supra* note 1, at 92.
114. Int. Rev. Code § 661(e).
115. Int. Rev. Code § 6686.
116. Int. Rev. Code § 995.

995(b)(1) impose a tax on shareholders for certain constructive or "deemed" distributions.[117] These are:

(1) gross receipts derived from producer's loans;
(2) gain recognized on the sale or exchange of property, other than qualified export property, transferred to the DISC in a tax-free exchange;
(3) gain recognized on the sale or exchange of certain assets with recapture potential, whether or not qualified export assets, received by the DISC in a tax-free transfer;
(4) one-half of the excess of the taxable income of the DISC over the constructive distributions under the foregoing rules;
(5) the amount of foreign investment attributable to producer's loans; and,
(6) distributions that are deemed to be made when a DISC either revokes its election or fails to qualify as a DISC.[118]

Shareholders must account for these items at their gross amount, limited by the current earnings and profits of the corporation.[119] Nevertheless, in any year in which a DISC revokes its election or fails to qualify as a DISC, the shareholders are treated as receiving a pro rata distribution of all prior tax-deferred DISC income.[120] If the corporation qualifies as a DISC for ten or more years, this amount is deemed received by the shareholders in equal installments over a ten year period.[121] If the corporation was not a DISC for ten consecutive years, the deemed distributions are treated as received over the number of consecutive years the corporation was qualified.[122] The first "installment" is considered to have been made on the last day of the DISC's taxable year following the year of revocation or disqualification.[123] Furthermore, deemed distributions of previously accumulated DISC income continue even though the corporation might again qualify for deferral on new export income.[124]

Shareholders are taxed on the three types of earnings and profits of the DISC: accumulated DISC income;[125] previously taxed in-

117. INT. REV. CODE § 995(b).
118. INT. REV. CODE § 995(b).
119. INT. REV. CODE § 995(b).
120. INT. REV. CODE § 995(b)(2)(A).
121. INT. REV. CODE § 995(b)(2)(B).
122. INT. REV. CODE § 995(b)(2)(B).
123. S. REP., *supra* note 1, at 112. *See* INT. REV. CODE § 995(b)(2)(B).
124. S. REP., *supra* note 1, at 112.
125. INT. REV. CODE § 996(f)(1) (basically, this is the earnings and profits of the DISC for any taxable year after reduction of all constructive distributions).

come;[126] and other earnings and profits.[127] In general, the DISC's earnings and profits are absorbed by actual distributions in the following order: previously taxed income; deferred DISC income; and, finally, other earnings and profits.[128] In other words, actual distributions are treated as dividends only to the extent that they exceed previously taxed income. There are two exceptions to this general rule: first, distributions to meet qualification requirements;[129] and, secondly, any distribution relating to foreign investments attributable to a producer's loan. The Committee Report indicates that these distributions do not merit tax deferral since they are viewed as consisting of non-qualified assets or receipts.[130] The order of these distributions is deferred DISC income, other earnings and profits and, finally, previously taxed income.[131] If the DISC has a net operating loss in a particular year, the loss will reduce earnings and profits in the following order: other earnings and profits; deferred DISC income; and, then, previously taxed income.[132] If the DISC revokes its election or fails to qualify and is thus deemed to have made a spread-forward distribution of its accumulated DISC income, the loss may not be applied to reduce accumulated DISC income. It is applied first to other earnings and profits, next to previously taxed income and, finally, if there is any part of the loss left unapplied, to reduce earnings and profits in later years.[133] In order to avoid the bookkeeping complications inherent in these rules, a DISC may make actual annual distributions of dividends in the amount of any interest on producer's loans plus one-half of the remaining taxable income, thereby eliminating the necessity of accounting for income previously taxed to the shareholders.[134] The shareholders pay ordinary income tax on the amounts so distributed, while the DISC continues to hold its remaining income as tax deferred.

For purposes of characterizing the distribution in the hands of the shareholder, where more than one distribution is made during the taxable year, the order of priority will be as follows: constructive

126. INT. REV. CODE § 996(f)(2).

127. INT. REV. CODE § 996(f)(3) (basically, this component includes the undistributed income of a DISC which arose in years when it did not qualify for DISC status).

128. INT. REV. CODE § 996(a)(1).

129. See discussion of this type of distribution at pp. 478-80 *infra*.

130. S. REP., *supra* note 1, at 117.

131. INT. REV. CODE § 996(a)(2).

132. INT. REV. CODE § 996(b).

133. INT. REV. CODE § 996(b)(3).

134. HANDBOOK, supra note 4, at 28.

distributions; actual distributions made in order to qualify as a DISC; and, finally, other actual distributions.[135] In addition, constructive distributions will be considered as made on the last day of the DISC's taxable year.[136] Consequently, although a constructive distribution is applied first for purposes of characterizing it as a dividend or as previously taxed income, it is treated as the last distribution received by the shareholder. Actual distributions, other than qualifying distributions, will be taken into account in the order in which they are made.[137] These timing rules will be material if the DISC and the shareholders have different taxable years.

The rules governing constructive and actual distributions may be illustrated by the following comprehensive example. At the beginning of the 1979 taxable year the DISC has accumulated earnings and profits consisting of the following:

(1)	previously taxed income	$50,000
(2)	accumulated DISC income	$60,000
(3)	other earnings and profits	$30,000
		$140,000

The corporation qualified as a DISC from 1972-1977. In 1978 it did not qualify; however, it again qualified in 1979. For the taxable year 1979, it had taxable income and current earnings and profits of $100,000 and was considered to have made the following deemed distributions:

(1)	interest on producer's loans	$10,000
(2)	50% of the excess of taxable income over line (1)	$45,000
(3)	foreign investment attributable to producer's loans	$20,000
(4)	distributions due to disqualification in 1978 (*i.e.* one-sixth of $60,000 deferred income)	$10,000
		$85,000

135. INT. REV. CODE § 996(c).
136. S. REP., *supra* note 1, at 109.
137. *Id.*

In addition, the corporation made the following actual distributions during 1979:

(1)	distributions made in order to qualify	$40,000
(2)	other distributions	$150,000
		$190,000

The total of the constructive distributions ($85,000) is taxable to DISC shareholders as a dividend since it does not exceed the current earnings and profits of the DISC for the taxable year (*i.e.* $100,000). At this point, taking into account the constructive distributions, the various components of the DISC's earnings and profits are as follows:

(1)	previously taxed income	
	Beginning of 1979 taxable year	$50,000
	Plus: constructive distributions	$85,000
		$135,000
(2)	accumulated DISC income	
	Beginning of 1979 taxable year	$60,000
	Plus: deferred income	$45,000
		$105,000
	Less: distribution due to disqualification	$10,000
		$95,000
(3)	other earnings and profits	$30,000

Of the actual distributions, a total of $55,000 is taxable to the shareholders as a dividend. The $40,000 distribution made to qualify as a DISC is treated as being paid out of accumulated DISC income and is therefore taxable in full. The other distribution of $150,000 is treated as being from previously taxed income to the extent thereof ($135,000). The excess ($15,000) is treated as accumulated DISC income and is taxable as a dividend. At the end of the 1979 taxable year, the various components of earnings and profits are as follows:

(1)	previously taxed income	
	After constructive distributions	$135,000
	Less: $150,000 actual distribution to the extent of previously taxed income	$135,000
		0

(2) accumulated DISC income		
After constructive distributions		\$95,000
Less: (a) distributions due to disqualification	\$40,000	
(b) excess of other actual distribution over previously taxed income	\$15,000	\$55,000
		\$40,000
(3) other earnings and profits		\$30,000

Note that because of the 1978 disqualification of the DISC, it is considered to be distributing one-sixth of its deferred DISC income (\$60,000) in each of the taxable years 1979-1984. However, because of the actual distributions of \$55,000 out of accumulated DISC income, all remaining installments (1980-1984) are considered paid.[138]

If a shareholder disposes of his DISC stock in a taxable transaction resulting in a gain, section 995(c) provides for section 1248-type treatment.[139] Accordingly, the gain realized by the shareholder is taxed as a dividend to the extent of the shareholder's pro rata portion of the DISC's accumulated income during the period when the shareholder held the stock.[140] Gain in excess of accumulated DISC income is taxed at capital gain rates.[141] Redemption of the shareholder's stock by the DISC is treated similarly.[142] In addition, if DISC stock is disposed of in a transaction in which the separate corporate existence of the DISC is terminated, such as an "A" or "C" reorganization, or a liquidation, dividend treatment will apply to the extent of accumulated DISC income.[143] Since a "B" reorganization does not involve the disappearance of the corporate entity, this type of reorganization will not result in dividend treatment.[144] If it is followed by a liquidation, however, this rule would not apply. In

138. 2 CCH 1972 STAND. FED. TAX REP. 329 (Feb. 14, 1972).
139. Rothkopf, *supra* note 1, at 137.
140. INT. REV. CODE § 995(c).
141. *See* INT. REV. CODE §995(c).
142. S. REP., *supra* note 1, at 114.
143. *Id.*
144. *Id.*

relation to corporate divisions, the Senate Report states that "the shareholders . . . will not be treated as receiving ordinary income by reason of the DISC rules."[145] Furthermore, gifts of DISC stock during the donor's lifetime or transfers by reason of death do not result in taxation of the untaxed accumulated DISC income.[146]

In a transaction other than a redemption, there are no adjustments made at the corporate level.[147] The purchaser or other transferee, however, may treat later actual distributions as made from previously taxed income to the extent that these distributions do not exceed the amount taxed as a dividend to the seller or other transferor.[148] To the extent that this special adjustment is not exhausted by the first transferor, it may be used by a subsequent transferor.[149] In a redemption, the adjustment is made at the corporate level,[150] and accumulated DISC income is reduced by the sum of the amount treated as a dividend by the shareholder and the amount of the shareholder's unexhausted special adjustment.[151]

Finally, there are several important collateral provisions bearing on DISC shareholder taxation: basis adjustment; the dividends received deduction; consolidated returns; and the foreign tax credit. The basis of a DISC shareholder's stock is increased by the amount of any constructive distribution taxed to the shareholder.[152] Basis is reduced by the amount of previously taxed income that is distributed to the shareholder tax-free.[153] If the distribution of previously taxed income is greater than the basis of the shareholder's stock, however, the excess is treated as gain from the sale or exchange of property.[154] This follows the general rule that distributions in excess of basis are treated as capital gains.

Corporate shareholders are not entitled to the dividends received deduction to the extent that a distribution is absorbed by previously taxed income, accumulated DISC income or current DISC income.[155] The dividends received deduction is designed to prevent multiple taxation of corporate earnings as they pass from one corporation to

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145. *Id.*
146. *Id.*
147. *Id.*
148. *Id.*
149. *Id.*
150. *Id.*
151. *Id.*
152. INT. REV. CODE § 996(e)(1).
153. INT. REV. CODE § 996(e)(2).
154. INT. REV. CODE § 996(e)(2).
155. INT. REV. CODE § 246(d).

another. Since a DISC is not taxed on its earnings and profits, the general rule has no application.[156] If the distribution is considered to be from other earnings and profits, however, the dividends received deduction will be available.[157] For the same reason that a corporate shareholder is denied the dividends received deduction, a DISC may not be included in a group of affiliated corporations electing to file a consolidated return.[158]

Generally, DISC shareholders are entitled to the foreign tax credit for taxes paid by the DISC.[159] The credit, however, is allowable only for that portion of a DISC dividend that is attributable to qualified export receipts,[160] since only these amounts are treated as foreign source income.

IV. Other Important Provisions

A. *Qualification Distributions*

In order to prevent a DISC from failing to qualify in a particular year merely because of its failure to meet the gross receipts or assets test, the statute includes provisions under which distributions may be made by the corporation after the close of its taxable year.[161] There are two types of qualifying distributions: reasonable cause and reasonable cause assumed.

The "reasonable cause" type of distribution is designed to deal with the situation where there is both reasonable cause for the corporation's failure to meet the respective tests and for its failure to make the distribution earlier.[162] The Committee Report indicates that reasonable cause to permit qualifying distributions under this test would be established if the failure to meet the tests occurred in "good faith," such as a subsequent price adjustment or an unanticipated insurance recovery.[163] Additional examples of reasonable cause are failure resulting from blocked currency, foreign expropriation or reasonable uncertainty about what constituted a qualified receipt or

156. S. Rep., *supra* note 1, at 124.
157. Int. Rev. Code § 246(d).
158. Int. Rev. Code § 1504(b)(7).
159. Int. Rev. Code § 901(d).
160. Int. Rev. Code § 901(d).
161. S. Rep., *supra* note 1, at 94.
162. S. Rep., *supra* note 1, at 95.
163. *Id.*

asset.[164] Provided reasonable cause is established, the distribution may be made at any time before or after the close of the DISC's taxable year, including at the time of a later tax audit.[165] The corporation, however, must pay a charge equal to 4½ per cent of the distribution times the number of taxable years that the distribution is delayed.[166]

The "reasonable cause assumed" type of distribution is designed to apply in those cases where the corporation comes relatively close to satisfying the gross receipts or assets test.[167] In order to satisfy the requirements of this category, at least 70 per cent of the corporation's receipts and assets must have been qualified receipts and assets for the taxable year.[168] In addition, the distribution must be made within eight and one-half months after the close of the corporation's taxable year.[169] In addition to satisfying the requirements of one of the above types, the distribution must meet the following conditions:

(1) it must be pro rata to the shareholders;
(2) it must be specifically earmarked as a distribution to meet DISC qualification requirements;[170]
(3) if the failure was in regard to the "receipts test," it must be equal in amount to *all* taxable income attributable to non-qualified receipts;
(4) if the failure was in regard to the "assets test," it must be equal in amount to the fair market value of *all* non-qualified assets on the last day of the taxable year;
(5) if the failure was in regard to both tests, it must be equal in amount to the sum of the amount determined under (3) and (4) above.[171]

It is important to note that the entire amount described in (3) and (4) above must be distributed and not simply an amount equal to the extent to which the corporation failed to satisfy the particular test

164. HANDBOOK, *supra* note 4, at 29.
165. *Id.*
166. S. REP., *supra* note 1, at 96. Since the charge is imposed on the entire amount of the distribution, this is equivalent to a 9% rate if the distributions were taxable at 50%. *Id. See* HANDBOOK, *supra* note 4, at 29.
167. S. REP., *supra* note 1, at 95.
168. INT. REV. CODE § 992(c)(3).
169. INT. REV. CODE § 992(c)(3).
170. A corporation which makes a normal distribution and then subsequently discovers that it did not meet the qualification test for the preceeding year is not permitted to redesignate the initial dividend distribution as a qualification distribution. S. REP., *supra* note 1, at 94.
171. INT. REV. CODE § 992(c)(1).

involved. Furthermore, a qualification distribution is taxable to the shareholders in full; it does not qualify for the dividends received deduction, and it has no foreign tax credit consequences.[172]

B. *Intercompany Pricing Rules*

The new legislation provides special intercompany pricing rules that may be used as a guide for the prices charged to DISC's by their related supplier, whether or not the related supplier is the manufacturer.[173] These new rules permit avoidance of section 482, if desired.[174] Consequently, the rules allow the DISC to earn greater profits than would be possible under the normal pricing rules.[175] Under these rules, regardless of the price actually charged, the transfer price to the DISC is the greater of the amounts calculated by using the following formulas:

(1) 4 per cent of the qualified export receipts arising from the sale plus 10 per cent of the export promotion expenses attributable to the sale; or,

(2) 50 per cent of the combined taxable income of the DISC and the related seller arising from the sale plus 10 per cent of the DISC's export promotion expenses.[176]

Export promotion expenses are the ordinary and necessary distribution expenses incurred in order to obtain "qualified export receipts," such as advertising expenses, salaries and wages of sales, clerical and other personnel, rentals, sales commissions and other sales expenses.[177] On the other hand, expenses are not included that do not directly or indirectly further the distribution of export property for use abroad.[178]

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172. S. REP., *supra* note 1, at 94.

173. *See* INT. REV. CODE § 994.

174. Section 482 provides that the transfer price charged to a related party must be essentially the same as that charged to an unrelated party. This "arms length" standard acts as a limitation on the amount of profits a related party can earn. *See generally* Bagley, *DISC: How the Latest Tax Incentive Works and When It Is Used,* 8 TAX. ACC. 150, 154 (1972).

175. *Interpreting the U.S. DISC Law: Corporate Reactions Show Cautious Acceptance,* 19 BUS. INT'L 65, 66 (1972).

176. INT. REV. CODE § 994(a)(1)-(2).

177. HANDBOOK, *supra* note 4, at 27.

178. *Id.*

The Senate Report indicates that "pricing" may be either on a product-by-product basis or on a production line basis.[179] In addition, price adjustments may be made at the end of the taxable year in order to obtain the most favorable allocation of income permitted.[180] In no event, however, may these rules operate to cause the related manufacturer to incur a loss on a sale to the DISC.[181] Moreover, the special pricing rules apply only on sales by the related manufacturer to the DISC and do not apply to resales by the DISC to others.[182] On resale, the applicable rules are those set forth in the regulations under section 482.[183]

C. *Producer's Loans*

The tax-deferred profits of a DISC may be loaned to any person engaged in manufacturing, producing, growing or extracting property in order to finance an increase in the borrower's assets that are deemed export related, provided certain conditions are met.[184] Such a loan is termed a "producer's loan." It may be used to facilitate the formation of an economic relationship between the DISC and its supplier through joint financing of their facilities, inventory, and research and development.[185] In general, the concept permits the DISC to increase its tax deferred potential since the loan must be made out of the DISC's accumulated income. Furthermore, a producer's loan will not be treated as a constructive dividend.[186]

The loan, however, must be evidenced by a note with a stated maturity date of not more than five years from the date of the loan,[187] must be designated as a "producer's loan,"[188] and must be attributable to assets used in export production.[189] In addition, the loan must not exceed the smallest of the following:

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179. S. REP., *supra* note 1, at 107.
180. HANDBOOK, *supra* note 4, at 25.
181. *Id.*
182. HANDBOOK, *supra* note 4, at 24.
183. HANDBOOK, *supra* note 4, at 27.
184. Where the 7% job development credit would ordinarily apply to the acquisition of assets, the credit remains available even though the assets purchased are deemed export related and are financed through producer's loans. HANDBOOK, *supra* note 4, at 4.
185. HANDBOOK, *supra* note 4, at 2.
186. HANDBOOK, *supra* note 4, at 20.
187. INT. REV. CODE § 993(d)(1)(B).
188. INT. REV. CODE § 993(d)(1)(D).
189. S. REP., *supra* note 1, at 103.

(1) an amount which, when added to the unpaid balance of all other producer's loans made by the DISC, does not exceed its accumulated DISC income;[190]
(2) an amount which, when added to the unpaid balance of all other producer's loans made to the same borrower, does not exceed that part of the assets of the borrower which is devoted to manufacture, etc. for export;[191] or,
(3) an amount which, when added to the unpaid balance of all other loans made to the same borrower during the taxable year, does not exceed the total increase in the assets of the borrower from the beginning to the end of the borrower's taxable year in which the loan was made.[192]

If any portion of the producer's loan results in a net increase for the year in plant and equipment of the corporate group which is located abroad, the so-called "fugitive capital" rule terminates deferral on that portion.[193] In addition, the rate of interest charged on a producer's loan must meet the "arms length" standards of section 482.[194] These significant limitations are designed to counter the objection that DISC profits could be used to build more plants abroad.

If the loan is qualified when made, it will remain qualified until its maturity.[195] The loan may be renewed, however, only if the requirements are met at the time of renewal.[196] Furthermore, a qualified loan will be treated as a qualified asset for purposes of the "asset test."[197] Similarly, interest on a producer's loan constitutes a qualified receipt for purposes of the "gross receipts test."[198] Such interest, however, is treated as distributed to the DISC shareholders in the year earned by the DISC,[199] whether or not an actual distribution was made.

V. Conclusion

The significant tax incentive afforded by the DISC provisions requires all United States companies selling or leasing goods abroad, or rendering services abroad, to reappraise their present corporate and

190. INT. REV. CODE § 993(d)(1)(A).
191. INT. REV. CODE § 993(d)(2).
192. INT. REV. CODE § 993(d)(3).
193. INT. REV. CODE § 995(d).
194. HANDBOOK, *supra* note 4, at 21.
195. HANDBOOK, *supra* note 4, at 20.
196. HANDBOOK, *supra* note 4, at 22.
197. INT. REV. CODE § 993(b)(5).
198. INT. REV. CODE § 993(a)(1)(F).
199. INT. REV. CODE § 995(b)(1)(A).

tax structures. Those companies that have not exported in the past or have done so on a limited basis should reconsider their prior positions and calculate the benefits to be derived from export transactions. Notwithstanding inherent complexities and uncertainties[200] in the new law from a tax standpoint, export transactions are now more profitable to a United States company than comparable sales made within the United States. Additionally, the DISC provisions remove the tax discrimination which existed under prior law against United States manufacturers engaged in export activities through domestic companies.[201]

Although an export company must organize as a separate corporation, it will not be subject to the possible tax disadvantages of the corporate form. Furthermore, the technical qualification requirements may be satisfied easily if the DISC acts as a selling arm for its parent manufacturer or if it handles the exports of a number of United States manufacturers. Similarly, provisions exist that prevent easy disqualification. Even if the corporation fails to qualify in a particular year, the "installment method" of taxing the deferred income should mitigate any adverse consequences. In any event, compliance with the DISC provisions should prove easier than foreign incorporation since many of the legal, accounting and tax complexities peculiar to the foreign corporation can be avoided with a DISC. Moreover, the restrictions on the amount of deferral are so liberal that DISC shareholders should be able to shield large amounts of income from total taxation. At the corporate level, the new intercompany pricing rules not only help to reduce the previous problems in relation to parent-subsidiary transactions but also increase the amount of profits a DISC can earn. Consequently, the DISC provisions provide the taxpayer with a substantial new tax incentive to increase exports through a restructured corporation.

William J. Chadwick

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200. For example, how will the states tax DISC income?

201. Prior tax law favored sales by foreign subsidiaries over exports from the United States. S. REP., *supra* note 1, at 40. United States corporations engaging in export operations were taxed on their foreign earnings at the highest U.S. corporate tax rate whether they were kept abroad or repatriated. *Id.* In contrast, United States corporations which produced and sold abroad through foreign subsidiaries could postpone tax on their earnings as long as they were kept abroad. *Id.* Furthermore, other major trading nations encourage foreign trade by domestic producers in one form or another. Where value added taxes or multi-stage sales taxes are used to any appreciable extent, the practice is to refund taxes paid by the exporter at the time of export and to impose these taxes on importers. In the case of income taxes, however, most of the major trading nations have features in their tax laws which tend to encourage exports. *Id.* at 91.