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## DOMESTIC INTERNATIONAL SALES CORPORATIONS

GEORGE CAREY\*

In late 1971, after several years of effort by the Nixon administration and various industry groups, Congress enacted a complex group of tax provisions designed to encourage exports from the United States. These provisions, DISC, are the subject of this paper.<sup>1</sup>

### GENERAL REQUIREMENTS FOR QUALIFICATION AS A DISC

A Domestic International Sales Corporation (hereinafter, DISC) must be a corporation. It is clear from the legislative history of the DISC provisions that the requirement of incorporation for DISCs is primarily intended to simplify record-keeping and audit, especially in connection with pricing transactions in which the DISC participates.<sup>2</sup> Reflecting this basic purpose, the formal requirements a corporation must meet to be treated as a DISC are not very difficult to satisfy, and corporations that might be attacked as mere alter egos of their shareholders were they not DISCs are expressly recognized as separate taxable entities.

To qualify as a DISC an entity must be actually incorporated under the laws of a state or the District of Columbia, and may not merely be an association or other entity taxable as a corporation.<sup>3</sup> A possessions corporation is not eligible for DISC status. The entity must have at least \$2,500 of capital, in par or stated value of stock, and only one class of stock is permitted. A separate bank account, and separate books and records must be maintained. Each of the shareholders must consent to an election which must be filed by the corporation. If each of these requirements is met, subject to the Qualified Export Receipts and Qualified Export Assets requirements for each year, the corporation will be

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1. The principal DISC provisions are found in sections 991-997 of the Internal Revenue Code of 1954 (hereinafter, Code). References to sections are to be assumed references to the Internal Revenue Code of 1954 unless otherwise noted. The author gratefully acknowledges the many helpful suggestions and criticisms of Professor Stanley S. Surrey.

2. See, S. Rep. 92-437, 92d Cong. 1st Sess. (1971), p. 93. (hereinafter, Senate Report).

3. Reg. § 1.992-1 (a).

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treated as a DISC, and as a separate entity for tax purposes from its shareholders.<sup>4</sup>

In order to qualify as a DISC for a taxable year a corporation must meet a gross receipts and an assets test. Under the gross receipts test, the DISC must realize 95 percent of its gross receipts in the form of "Qualified Export Receipts" (hereinafter, QER).<sup>5</sup> Generally such receipts are those realized from export transactions involving sale or lease of "export property" or performance of certain services.<sup>6</sup> As will be dealt with more fully herein, failure to qualify under the gross receipts test may be cured by distributions after the close of the taxable year in many cases.

Under the assets test, the adjusted bases of the "Qualified Export Assets" (hereinafter, QEA) of the DISC must constitute 95 percent of the adjusted bases of all assets of the DISC.<sup>7</sup> Generally QEA are assets which relate to export transactions which produce QER, including inventory of property held for sale in export transactions.

Since the QEA test is applied as of the end of the taxable year of the DISC, to prevent the temporary acquisition of assets solely to meet the test, Reg. § 1.992-1(c)(2) provides that assets must be differentiated between those which were held 60 days or less and acquired "directly or indirectly" through borrowing on the one hand, and those which were otherwise acquired or held for a longer period on the other. As to the former, the DISC must show that the assets were acquired for "bona fide" purposes, for example in the usual course of the DISC's business activities. There are several unresolved questions under this rule.

Perhaps the most difficult aspect of Reg. § 1.992-(c)(2) is determining when an asset will be considered acquired with borrowed funds. The case where the asset was purchased with funds expressly borrowed for that purpose would seem to present little difficulty, the asset would clearly come within the rule if the 60 day test was met and the DISC would have to show it was acquired for "bona fide" purposes in order to count the asset as QEA. If, however, the DISC has borrowed funds not for the express purpose of acquiring the asset in question, it is not clear whether a broad or narrow meaning of "indirect" is intended. For example, it could be argued that any acquisition of assets is indirectly with borrowed funds if there are any borrowings, since the borrowing

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4. *Id.* The separate bank account requirement must be met on each day of the taxable year, except where a newly formed corporation elects DISC treatment for its first year.

5. The requirement of 95 percent QER is in section 992 (a) (1) (A), and such receipts are defined in section 993 (a).

6. Section 993 (a). Export property is defined in section 993 (c).

7. The requirement of 95 percent QEA is in section 992 (a) (1) (B), and such assets are defined in section 993 (b).

frees funds not borrowed for the acquisition of the asset. On the other hand, a narrow reading of indirect would be that there must be some motive shown connecting the borrowing and the acquisition of the asset. For example, under such a reading the Service might show that there was conscious consideration of the consequences (under the rule) of acquiring the particular asset with funds borrowed expressly for that purpose, and that because of those consequences existing funds earmarked for another purpose were shifted to the acquisition of the asset, and the borrowed funds shifted to such other purpose. The question appears to be fairly important because it would appear from the structure of the rule, setting forth a mechanical test and shifting the burden of showing the purpose (or absence of "bad" purpose) for acquisition of the asset to the DISC, that ease of administration was one goal. If, however, a narrow construction is put on the term "indirect", in effect the administrative burden of showing a "bad" purpose is put back on the Service, since the Service will have to show in some detail the motive for acquiring the asset as a part of showing that the borrowed funds related to the asset in question.

It is also unclear what is meant by "bona fide". Presumably this refers to some purpose for the acquisition of the asset other than to satisfy the 95 percent QEA test. But it does not make clear the role of business exigencies when they are combined with tax motives. For example, what result in the case where the DISC acquires an asset primarily to meet the test, but intends to hold it for a period longer than the 60 days which keys in the rule, and the asset is disposed of for exclusively business reasons within the 60 day period? Since DISC is a creature of tax incentive it would seem that even an acquisition solely to qualify the DISC would be bona fide in a sense, since Treasury actively encourages the formation of DISCs; that is, it seems to make little sense to say on the one hand that significant tax rules will be waived to encourage taxpayers to create DISCs, and favorable tax treatment will be accorded them if they do, but to say on the other hand that all acquisitions of assets to maintain qualified status are somehow undesirable. While the wording of the rule suggests that the "bona fide" test is applied as of the time of (and to the facts surrounding) the acquisition of the asset, and not to the time of or facts surrounding its disposal, it is possible that the DISC, in a case such as the above, could argue that acquisition of the asset was bona fide because the DISC intended to keep the asset more than 60 days.

The requirement that a DISC have only one class of stock is designed to simplify record-keeping and the application of the operational rules for DISCs. The required \$2,500 capital must be actually paid in, in cash or other property, precluding issuance of the minimum required

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stock for services. If the DISC suffers a loss which would impair its capital under state law, the \$2,500 requirement will continue to be satisfied unless formal action is taken to reduce capitalization.<sup>8</sup>

In view of the minimum capitalization requirements, it is conceivable that some of the DISC's "debt" would be treated as "equity" under the usual Code "debt-equity" rules. To avoid this result, the regulations relax the usual debt-equity rules, and create two categories of obligation which will be treated as debt whether or not they would be so treated under the usual rules of the Code.<sup>9</sup>

Under the regulations,<sup>10</sup> debt is divided into two groups, obligations which would be recognized as debt under the usual Code rules, and obligations which would not be so recognized. The latter are again divided into two categories, obligations which fit within one of the two special categories of the regulations, and those which do not. As to the latter, they are subject to the normal Code rules. The first of the special categories is debt which meets the "safe harbor" rule.<sup>11</sup>

An obligation will be treated as debt under the "safe harbor" rule if it is evidenced by a written obligation, is for a fixed amount and with a fixed maturity, the DISC is required to pay a fixed percentage or amount as interest (and if such percentage or amount is arm's length under the rules of Section 482 and regulations 1.482-2(a)(2)), is not subordinated to general creditors of the DISC (as to either principal or interest), is not convertible into stock or other debt (unless the "other debt" would qualify as debt under the normal Code rules or one of the two special DISC debt rules), there is reasonable expectation when the obligation is created that the debt will be paid, the debt has no voting rights except upon default, and the interest is paid.<sup>12</sup> Such debt is referred to in the regulations as "safe harbor" debt. In determining whether an obligation qualifies under these tests, the proportion held by particular shareholders is ignored, as is the ratio of debt to equity and the amount of debt (*i.e.*, the thin capitalization rules do not apply). Modifications of the terms of the debt are permitted if the DISC is unable to pay so long as they are consistent with the requirements stated above, though it is hard to see in some cases how the requirement that there is a "reasonable" expectation that the DISC will pay can be met. Although it is not explicitly stated, presumably the general rule that a DISC will be recognized as a separate entity for tax purposes if it meets

8. Reg. § 1.992-1 (d). The final regulations added a limitation under which debt obligations of a shareholder exchanged for the corporation's stock do not count towards the \$2,500 required.

9. Reg. § 1.992-1 (d) (2).

10. *Id.*

11. Reg. § 1.992-1 (d) (2) (ii).

12. *Id.*

the formal requirements for DISC treatment will apply here, and payments of "interest" on safe harbor debt will not be treated as dividends to shareholders.

The effect of the "safe harbor" rule would often not be advantageous to the taxpayer. For example, if the DISC had \$5,000 taxable income for the taxable year, and paid "interest" of \$500 on an obligation which was treated as debt only because of the "safe harbor" rule, the DISC's taxable income would be reduced to \$4,500 [because of the deduction under Section 163 (or 162) for the interest paid]. This would reduce the deemed distribution to the shareholder from \$2,500 to \$2,250, but because the shareholder-debtor would have to include the "interest" payment in his income, he would have taxable income from DISC distributions for the year of \$2,750. If the debt had been treated as stock (ignoring the one class of stock rules) it is likely that the distribution could have been so arranged that it would be treated as coming from "previously taxed income" (generally, the portion of the DISC's earnings and profits which has been taxed to the shareholders as "deemed distributions" even though not actually distributed) and thus would not be taxable to the shareholder-creditor. While the DISC's taxable income would not be reduced, because no deduction would be allowed for the payment, and thus the deemed distribution would be \$2,500, the amount taxed to the shareholder for distributions from the DISC for the year would be only \$2,500. This example points out two things: it is generally better not to put a deduction in a DISC since its value is somewhat reduced, and that the real benefit from the special DISC debt rules is in avoiding the one class of stock requirement for thinly capitalized DISCs. In short, the taxpayer pays a price in larger taxable income for distributions from the DISC by capitalizing the DISC with debt capital, but he presumably benefits overall by continued qualification of the DISC.

A possible abuse of the "safe harbor" rule stems from the possibility that payments by the DISC will be characterized as repayment of the principal of the loan, rather than as redemptions of stock in cases where "debt" would be treated as "equity" but for the "safe harbor" rule. In such case, since the payments would be treated as a return of capital to the shareholder-creditor, they would not be included in his income, and he would realize no gain on the repayment. The taxable income of the DISC would not be reduced, so the amount of the regular deemed distribution from the DISC would not be reduced, but the shareholder would be in pocket after taxes more than if the payment was treated as a payment of interest, and future distributions would be more likely to be treated as from previously taxed income (and thus not taxable to the

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shareholder-creditor) because the repayment of principal by the DISC would not reduce the previously taxed income account. The special rule of section 995(c), which treats disposition of DISC stock as the occasion for dividend treatment to the extent of DISC income not yet taxed, would also be avoided. Section 995 (c) would apply to a redemption by a shareholder of his DISC stock, but not apparently to a repayment of the principal of a loan. In effect what is allowed here is similar to a preferred stock bail out, the shareholder extracts earnings of the DISC by extracting capital as it is replaced by earnings, but retains his proportionate share of control by his stock ownership.

Reg. § 1.992-1(d)(2)(iii) contains a special rule for trade accounts payable. Generally these are not subject to the above described special rules for debt, but are always treated as debt of the DISC if they are payable within 15 months after they arise. Where accounts payable are payable more than 15 months after they arise, such accounts are subject to the above special rules for treatment as debt. In order for an obligation to be considered a trade receivable, and thus subject to this special rule rather than to the other rules for debt of a DISC, the item must have arisen in the ordinary course of the DISC's business. The probable intent of this condition for application of such treatment is to prevent disguising "debt" which would not qualify under the "safe harbor" or usual Code rules as a trade receivable, but it is not clear how the "ordinary course of business" requirement will be applied. For example, the regulations give as illustrations of such "ordinary course of business," consideration for inventory and supplies. But what result if a related person performed services for the DISC, and the DISC set up an account payable on its books in favor of the related person? Would the "ordinary course of business" requirement be applied to the performance of the services, the person performing the services, or the setting up of the account payable? It could be argued that it was not ordinary for the related person of the DISC to perform such services, and that they were so performed as a way of disguising a capital contribution to the DISC; that it was not ordinary for the DISC to have such services performed by another; or that it was not ordinary for such services to be compensated for by creating an account payable with a maturity, potentially (under the regulations) of more than one year. It is also unclear what the result would be if the account is not paid by the DISC at the time it is due. Perhaps a reasonable result would be to permit delinquency as a matter of course unless the account was payable to a member of the controlled group of the DISC since there would be little motive for disguising equity as debt where the obligation was owed to an unrelated person because such an obligation would be unlikely to be characterized as equity under the usual rules of the Code.

Proposed Reg. § 1.992-1(d)(3) provided rules for the one class of stock requirement; in the final regulations these rules are deleted, and the subparagraph "reserved". Generally these rules were quite similar to those under regulation § 1.1371-1(g) relating to the one class of stock requirement under subchapter S. Such an approach was probably taken to prevent any negative inference from arising as to the validity of the regulations under subchapter S (at the time the proposed regulations under section 992 were being drafted the appeal to the Ninth Circuit in *James A. Stimmert, Jr.*, was pending, in which the validity of the subchapter S regulations was being attacked by the taxpayer).<sup>13</sup> It appears the issuance of T.I.R. 1248 announcing the reconsideration by the Service of regulations 1.1371-1(g) will be deemed a sufficient reason to revise the proposed section 992 rules.<sup>14</sup> It seems unlikely that any eventual revision of these DISC rules will be very adverse to DISCs, since the very liberal rules on "debt" for DISCs would seem to remove a major source of potential contention between taxpayers and the Service which arises under section 1371.

Under a special rule of proposed 1.992-1(d)(3), even where "debt" failed to qualify for treatment as such under Reg. § 1.992-1(d)(2) it would be treated as a contribution to the capital of the DISC, rather than as a second class of stock, if such "debt" was held in approximately the same proportions as their stock by the shareholders. If holdings either of such "debt" or of stock were changed by any of the shareholders, the proposed regulations provided that a new determination must be made as to whether there was more than one class of stock. Presumably this caveat meant that a change in the proportion of holdings, either of such "debt" or of stock, would cause disqualification where it appeared such change in holdings was the second step in a use of the liberal debt-equity rules for DISCs as a bail out device.

Reg. § 1.992-1(f) provides rules relating to corporations which are ineligible for DISC status. Such ineligible corporations include tax exempt organizations, personal holding companies, financial institutions, insurance companies, China Trade Act corporations, regulated investment companies, and subchapter S corporations.

Reg. § 1.992-2 provides the procedures and requirements for making an election to be a DISC, and for filing shareholder consents.<sup>15</sup> Generally, a corporation is permitted to make an election to be a DISC within the first 90 days of its first taxable year (if it is a new corporation), or within the 90 day period preceding the beginning of the first taxable

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13. 54 T.C. 221 (1970).

14. T.I.R. 1248, July 27, 1973.

15. See also Temporary Reg. 12.7, 37 Fed. Reg. 28657 (1972), and Rev. Proc. 72-12, I.R.B. 1972-2, 25.



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year for which DISC treatment is desired (in the case of an existing corporation). Consents by the shareholders of the DISC to the election (and thus in effect to their taxation on the deemed distributions from the DISC) are generally to be filed with the election by the DISC, and are generally binding on transferees of such shares. The election by the DISC will remain in effect until the DISC revokes it or fails to qualify.

An election to be treated as a DISC may be terminated for any taxable year of the DISC after the first for which it has elected. Generally a notice of termination of election filed within the first 90 days of a taxable year will be effective for that taxable year, and one filed after such first 90 days will be effective for the following taxable year. Mere failure to qualify as a DISC for one taxable year (for example because the 95 percent QER test is not satisfied) will not terminate the election of the DISC for subsequent years. Continued failure for five consecutive years, however, will terminate the election.<sup>16</sup>

In this connection, the rule of Reg. § 1.992-1(g) should be noted. Under that provision a corporation filing a return as a DISC for a taxable year will generally be treated as a DISC for such year even though it does not in fact qualify, if the Service does not notify the corporation that it does not qualify, or the corporation does not notify the Service that it fails to qualify, within the period of limitation for assessments of additional tax for the year in question. Thus, if a corporation failed to qualify as a DISC for the second, third, fourth, and fifth years after it filed an election, and had filed regular corporate returns for those years, but had also failed to qualify for the first taxable year of the election but had filed a return as a DISC for such first year, and the conditions of Reg. § 1.992-1(g) were met, the election of the corporation would not be automatically terminated under the five disqualified years rule,<sup>17</sup> because the first year of the election would be treated as a qualifying year for that purpose. Continuing the example, if the corporation met the requirements for qualification as a DISC for the sixth taxable year of the election, the DISC's election would also not be automatically terminated under the five year rule, because such qualification year would start a new five year period running.

If a corporation meets the above formal requirements for qualification as a DISC, it will be treated as an entity separate from its shareholders for tax purposes, and the normal rules of the Code for determining when income is earned by one commonly controlled or controlling taxable entity rather than another are relaxed.<sup>18</sup> The regulations stress

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16. Section 992 (b) (3) and Reg. 1.992-1 (e) (3).

17. *Id.*

18. Reg. § 1.992-1 (a) (1).

the abnormality of this treatment, and urge that it not be extended by inference to other taxable entities. This hope will probably be realized since it is clear that DISC is expressly designed as a set of exceptions to the usual rules of the Code, and that what makes sense for DISC may not make sense in other parts of the Code.

A qualifying DISC is exempt from all taxes under subtitle A of the Code except those of chapter 5.<sup>19</sup> Since chapter 5 relates to taxation of personal holding companies, and a personal holding company is ineligible to be a DISC, this carve out from the exception should have little effect.

DISC treatment is year-by-year, that is, even if a corporation qualifies for one year, it may not qualify for another. This raises one of the most difficult issues in DISC, and one which is, most unfortunately, not adequately dealt with in the regulations: what happens to a corporation in non-qualifying years? As noted above, it is clearly contemplated that the recognition of the DISC as a taxable entity separate from its shareholders is an exception from the usual rules of the Code. Would a DISC that was recognized as a taxable entity only because of the DISC rules be treated as a separate entity in non-qualifying years? If not, how would it be treated?

In examining this question a basic distinction must be drawn between treatment as a separate entity for tax purposes and treatment of an item of income as earned by the disqualified DISC or by its controlling shareholder. It is possible for the disqualified DISC to be treated as a separate entity, but for all or some of its income to be treated as having been earned by the controlling shareholder. For example, if a disqualified DISC performed no function in a particular transaction, or the function performed by its controlling shareholder far outweighed the function performed by the disqualified DISC, under the usual rules of the Code all or nearly all income from the transaction should be reported by the controlling shareholder.<sup>20</sup> A distinction must also be drawn between items attributable to years of qualification which are carried over to disqualified years (accumulated DISC income, for example<sup>21</sup>), and items attributable to disqualified years.

It would appear under the case law relating to "straw corporations" that performance of almost any function, or even possession of the indicia of separate existence (for example, a separate bank account) would arguably be a basis for recognition of the existence of the

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19. Section 991 and Reg. 1.991-1 (a).

20. See, e.g., *American Savings Bank*, 56 T.C. 828 (1971).

21. See section 996 (f) (1) and Reg. 1.996-3 (b) for definition of accumulated DISC income.

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disqualified DISC as a taxable entity separate from its shareholders.<sup>22</sup> If the DISC's participation in transactions after disqualification is no greater than that contemplated during qualification by the DISC rules, however, it is doubtful that the DISC would be considered to have "earned" any income. For example, income may be attributed to a DISC from an export sale with little or no participation by the DISC, if the DISC is treated as a commission agent<sup>23</sup>; it would seem unlikely that such income would be treated as earned by a disqualified DISC under the usual rules of the Code, and an allocation of such income to the controlling shareholder of the DISC, where such controlling shareholder was the principal in the sale, would be the likely result.<sup>24</sup>

One of the more difficult problems under the DISC rules is the treatment of items in years the DISC fails to qualify. Under the proposed regulations one of the most difficult issues was treatment of "debt" which would, under the usual debt-equity analysis, be treated as "equity", but which was treated as "debt" because of the special DISC rule of Reg. § 1.992-1(d)(2). In the final regulations language was added in subdivision (iv) of that provision which goes part way to clearing up that issue—the special DISC debt rules are to apply only to years the DISC qualifies or is treated as qualifying under the uncorrected return rule of Reg. § 1.992-1(g). The cryptic nature of the new subdivision (iv) rule, however, leaves open some questions—will a particular item be treated as "debt" one year, "equity" the next, and "debt" again the year after?

Generally the income of the DISC from qualified years is carried in two accounts, previously taxed income, and accumulated DISC income.<sup>25</sup> The former is income which has been deemed distributed, and thus taxed, to the shareholders of the DISC, and the latter is generally the portion of the DISC's income which has not yet been taxed. Under section 995(b)(2) this untaxed portion of the DISC's income is treated as distributed, and thus taxed, to the shareholders of the DISC over the lesser of the ten year period following disqualification or the period for which the DISC was qualified. Section 995(c) provides for the case where the existence of a disqualified (or former) DISC is terminated before all accumulated DISC income is distributed under section 995(b)(2). But there are no rules dealing with the case where the qualification of a DISC is terminated; it is not recognized as a separate taxable entity from its shareholders for such disqualified years, and it

22. See Kronovet, *Straw Corporations: When Will They Be Recognized: What Can And Should Be Done*, 39 JOURNAL OF TAXATION 54 (July, 1973).

23. See Reg. § 1.993-1 (1).

24. *Supra*, note 19.

25. Section 996 (f) and Reg. § 1.996-3 (a), (b), (c).

has accumulated DISC income for such disqualified years carried over from qualified years. The curious situation this would produce, if the deemed distributions after disqualification under section 995(b)(2) were to be made as contemplated by that section, is that a department of the controlling shareholder (the former DISC not treated as a separate entity) would carry in an account funds which would be included rateably in the income of the controlling shareholder, but which would presumably be fully available for use in the controlling shareholder's business. In other words, the controlling shareholder would have use of funds derived from income which had not been taxed.

One approach to this problem would be to treat a DISC which was not treated as a separate entity from its controlling shareholder after disqualification as having made an actual distribution in the amount of the accumulated DISC income at the time of disqualification. Under section 996(a) this should exhaust the accumulated DISC income account, and should result in taxation of such amounts immediately to the controlling shareholder. The amount of the distribution, however, would seem to be in the amount of the previously taxed income plus the amount of the accumulated DISC income to achieve this result under section 996(a)(1), since distributions are treated as made first from previously taxed income, and second from accumulated DISC income, so to exhaust the second amount, the first would have to be distributed as well.

The DISC provisions do not contemplate the situation involved here, and to some extent they would be more consistent with the gradual inclusion result (the "curious situation" above) than a constructed distribution at the time of disqualification. Thus, for example, the year-by-year nature of DISC treatment appears to contemplate an ongoing entity which will qualify for some years and not for others. Similarly, since it is clearly recognized that a DISC need have no substance, some inference may be drawn from the inclusion of the gradual-distribution-following-disqualification rule of section 995(b), without an exception for the situation here, that immediate distribution upon disqualification was not intended even though the DISC is a paper thin entity.

#### ACCOUNTING METHODS AND PERIODS

A DISC determines its taxable income in the usual manner for a corporation under the Code. Thus, the DISC must select a method of accounting, may elect accelerated depreciation, etc. Special rules are provided under section 995 for net operating losses and capital loss carryovers.

In its selection of a method of accounting a DISC is limited by a special rule under Reg. § 1.991-1(b)(2). If a DISC is a member of a

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controlled group (within the meaning of Reg. § 1.993-1(k), generally defined as in section 1563(a) with 50 percent substituted for 80 percent) it may choose a method only if it will not result in material distortion of the income of the DISC or of another member of the group. The regulations illustrate this rule with an example of material distortion where the DISC is on a cash method and makes sales on a commission basis for a member of the group which is on the accrual method, and where the seller "customarily" pays the DISC its commissions more than two months after the sales.<sup>26</sup> The regulations conclude this example involves material distortion because the seller deducts its commission before the DISC includes it in income, and if the seller is the principal shareholder of the DISC it will thus be reporting deemed distributions of the DISC's share of the commission income for a later year than that in which it reports the deduction for the commission. It may be questioned whether the regulations example poses very substantial distortion, since the seller would not receive any portion of the commission back as a distribution from an unrelated commission agent. The choice of two months in the example may suggest that a mere difference of accounting methods which permits the kind of distortion described in the example is not sufficient, but that something more, such as longer than usual period of payment of commissions so the distortion potential of the difference in accounting methods will be utilized, will be required. If this is what is intended by the regulations it is hard to see how the rule is workable, since it relates the choice of accounting method to the way in which that method is used in practice. In other words, it would appear that the business practices of the DISC and its related persons will have to be read back into the choice of accounting method to find distortion within the meaning of the regulations and especially the example therein.

As with other corporations, a DISC generally must satisfy the requirements of section 446(e) to change its method of accounting. Assuming it does not run afoul of the distortion standard, the DISC may choose an annual accounting period without regard to that of its shareholders.<sup>27</sup> This permits an increase, in effect, of the deferral under the DISC provisions, since it permits the DISC to choose an accounting period which ends with the first month of the taxable year of the controlling shareholder. Since deemed distributions of DISC income are treated as made as of the end of the DISC's taxable year,<sup>28</sup> the shareholder will not have to report DISC income on its return until more than 11 months after the distribution is treated as made. The require-

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26. Reg. § 1.992-1 (b) (2).

27. *Id.*

28. Section 995 (b).

ment of estimated tax payments would seem to reduce somewhat the effect of this double deferral.

Along with the new regulations under the DISC provisions is a change to the regulations under section 442.<sup>29</sup> This regulation applies to DISCs the rules applicable to subchapter S corporations for changes in accounting period. Generally, the regulations would prevent a DISC from changing its annual accounting period to secure the benefits of deferral after the first taxable year of the DISC. Thus, the deferral effect implicit in initially choosing an annual accounting period beginning in the first month of the controlling shareholder's taxable year is permitted, but later such changes are not permitted, for example where shares are transferred to a new shareholder with a different taxable year than its predecessors. It is not clear whether this change to the regulations is really necessary, since it would seem unlikely that the Commissioner would consent to a change of accounting period which had no real purpose other than increasing deferral.

Reg. § 1.991-1(b)(4) permits a change of annual accounting period without consent of the Commissioner where the DISC is changing to the same period as its single shareholder, or to the period used by the members of a group of controlled corporations, of which it is one, who file a consolidated return. This, it appears, merely incorporates in the regulations the result which would obtain under non-DISC rules anyway, since it is likely the Commissioner would routinely give permission for such a change.

Extensive rules, not dealt with in this paper, are provided for corporations first electing DISC treatment for 1972.<sup>30</sup> Perhaps the most significant of these rules deals with situations, such as net operating losses, which would be created or aggravated by short taxable years which might result from such elections.

### QUALIFIED EXPORT RECEIPTS

As noted previously, 95 percent of the gross receipts of the DISC for the taxable year must consist of QER. The rules for determining when receipts are QER are set forth in section 993 and the proposed regulations thereunder, and rules for distributions to qualify when the 95 percent QER test is not met are set forth in section 992 and proposed regulations 1.992-3.

Generally, QER include receipts from the sale or exchange of export property and export assets, leases of such property, performance of services related to a sale or lease, performance of engineering and

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29. Reg. § 1.442-1 (c) (4).

30. Reg. § 1.991-1 (b) (3) (ii), (4), (5), Temporary Reg. 12.7.

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architectural services, performance of managerial services for other DISCs, and interest and dividends on certain export assets.<sup>31</sup> In each case the transactions giving rise to the receipts must involve an export or foreign location, and qualification of receipts from related persons of the DISC is limited.<sup>32</sup> The Treasury has authority under section 993(a)(2) to exclude receipts in certain cases from QER treatment, and some receipts are excluded by the statute, most importantly, perhaps, services other than which fall within the narrow categories described above.

Proposed 1.993-1(b) purports to define QER from sales of export property, but creates considerable confusion, apparently by an overly ambitious attempt of the draftsmen to combine in one sentence all the relevant rules for sales where the DISC acts as principal and where the DISC receives a commission from the principal. It appears clear that a sale by the DISC as principal of export property in an export transaction will produce QER for the DISC. If the DISC acts as commission agent for a related person or for an unrelated person, however, it is not clear from the proposed regulations whether the DISC (1) must be a party to the contract between the principal and the foreign buyer; (2) must have a contractual relationship under which it is entitled to a commission with the principal-seller; (3) must be a party or have such a contract, if one is required, at any particular time; or (4) whether it makes any difference in (1)-(3) above if the principal-seller is a related person of the DISC.

It appears that the DISC must participate in the transaction, either as a party to a contract with the foreign buyer or under some arrangement with the principal-seller, before the property is shipped to the foreign buyer. The wording is so obscure, however, (could an unrelated third person enter into a contract of sale with a foreign buyer, assign that contract to the DISC's related person, and then could that contract be reassigned to the DISC with this final step taking place after the property is shipped, but the other steps taking place before the property is shipped?) that it is impossible to say with any confidence what is meant.<sup>33</sup>

Receipts under proposed 1.993-1(b) will not be treated as QER unless the DISC qualifies at the time the goods are shipped to the buyer. This can give rise to rather anomalous results. For example, a corporation could be qualified as a DISC for taxable year one, but, it might

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31. Section 993 (a) (1) and proposed 1.993-1 (b) through (i).

32. Section 993 (b) and proposed 1.993-1 (g).

33. See *DISC: Panel Discussion, January 28, 1973*, 26 TAX LAWYER 537 at 552, where Mr. Robert J. Patrick, Jr., the present International Tax Counsel, United States Treasury, indicated some changes may be made in these rules.

later be determined, not for year two. If a sale was made in year one and payment received at that time, but the goods were not shipped until year two (for example, because of a delay beyond the control of the DISC), the receipts would not be QER. This might have a considerable effect on qualification of the DISC for year one, since it could cause failure of the 95 percent QER test. The effect could be particularly unfortunate if disqualification for year two was not determined until several years later (for example, upon audit by the Service). A more sensible rule might relate the status of the receipt to the status of the year in which it is includible in income by the DISC.

The rule discussed in the above paragraph is illustrated in the proposed regulations by an example in which the DISC sells property on the installment method, but is not qualified in the year the property is shipped. The more interesting aspect of the example is the reverse situation—what result if the DISC ships the property in a year for which it is qualified, but does not receive all the installments in qualified years? The example appears to suggest that the payments for non-qualified years might be subject to the DISC rules, a rather peculiar result, but one which may not have been intended by the example.

Receipts from leases, under proposed 1.993-1(c), are QER if the DISC or its lessor owns the property at the beginning of the lease, and the DISC qualifies for the first year of the lease. It is not clear whether a premature termination of a lease to enable a DISC to be inserted as a party to a new lease would produce QER. It appears that the rules of the proposed regulations attempt to require the DISC to participate from the beginning of the lease, but it is not clear whether the lease referred to is only the original lease, or would include a new lease as well.

Where disqualification of the DISC for some or all later years of a lease was feared (or planned) it would be possible to assure favorable tax treatment of lease proceeds by arranging for them to be prepaid. Proposed 1.993-1(c)(2) deals with this possibility by providing that prepaid lease proceeds will be QER only if it is "reasonably expected" at the time of the prepayment that the lease will qualify throughout its term. Apparently this means that it must be reasonably expected that the property will continue to be export property, and that the DISC will continue to qualify for the term of the lease. Where it appears at the time of prepayment that the lease would not produce QER throughout its term (for example, because the lessee plans to use the property in the United States at some future time), the prepayment will only qualify to the extent it is attributable to the expected period of qualification. Thus, if the lessee prepays for the full five years of a lease during the first year thereof, but makes known to the lessor his intention to move the



property to the United States for the fourth and fifth years of the lease, only three-fifths of the prepayment would be considered QER.

It is possible, because of the mechanical nature of the lease rules, for the DISC and its related person to take considerable advantage of lease proceeds and expenses. For example, if expenses may be incurred in one year rather than another, and one of those years is a year of expected qualification, choosing the year of nonqualification as the year for the expenses would be desirable because they would then reduce fully taxable income, rather than reducing combined taxable income, and thus perhaps the DISC's share of lease income in a qualified year. The difficulty here seems to be that DISC status is freely available, and may be chosen or not as the parties wish. When this is combined with year-by-year treatment of lease receipts, possibilities for shifting items become available. If this is viewed as an abuse, one cure would be to require all or nothing treatment of lease receipts: either all years would produce QER or none would.

Under section 993(a)(1)(c) and proposed 1.993-1(d) receipts from services which are related and subsidiary to a sale or lease of export property which produces QER will be treated as QER. Thus, for example, if a DISC sells office equipment in an export transaction and also contracts to service such equipment, the receipts for services as well as the receipts from the sale will be QER. Not only must the sale or lease to which services related produce QER, the sale or lease must, in effect, have produced QER for the DISC which performs the services. Thus, if services are performed under a contract between the DISC and a third party, the DISC must have been a principal or commission agent in the underlying sale or lease. The DISC is permitted to act as a commission agent for the performance of related and subsidiary services if it was either principal or agent in the underlying sale or lease.

Services are related to a sale or lease if it is customary and usual for such services to be performed in connection with such a sale or lease in the particular trade or business, and if the contract under which the services are performed is contemporaneous with the underlying sale or lease or is a renewal of such a contemporaneous contract.<sup>34</sup> Most services would appear to qualify under the proposed regulations, except financing services which are expressly eliminated.

Services are subsidiary, generally, if the receipts for such services are less than half the total receipts for services and the sale or lease to which they relate.<sup>35</sup> This determination is made on the basis of "reasonable expectations" at the time of the sale or lease, and with reference to

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34. Proposed 1.993-1 (d) (3).

35. Proposed 1.993-1 (d) (4).

expectations for the first ten years after a sale, or the initial term (without regard to renewals) of a lease.<sup>36</sup> Allocation of receipts between services and the sale to which they relate is made on the basis of facts and circumstances, and is not necessarily governed by the terms of contracts under which the services are performed.<sup>37</sup> Where services relate to more than one kind of export property, if the items of export property are included in the same product line, the receipts from services are included with receipts from all separate items of property to which they relate, and the determination under the 50 percent test is made with reference to the total.<sup>38</sup> Where services relate to items of export property which are not included in the same product line, presumably an allocation of the services among the items of property would be required.

Where a contract for the performance of services is renewed a separate determination must then be made of the subsidiary character under the 50 percent test.<sup>39</sup> This generally is made on the basis of the "reasonably expected" receipts for services as of the time of renewal. It is not entirely clear in the proposed regulations, but it appears that the test is to be applied to the total receipts from the sale or lease and the services throughout the period for which the services have been performed, and for which they are to be performed. For example, if a sale had been made for 100, and maintenance services during the first five years after such sale yielded 50, and if expected receipts from services under a renewal of the services contract totalled 60, the test would be applied by adding the receipts from the sale, 100, to the receipts for the first five years of services, 50, and to the receipts expected under the renewal, 60. The total receipts then would be 210 (100 + 50 + 60), and the services would fail the subsidiary test because receipts for them (110) were more than one-half the total receipts (210). There would be no retroactive disallowance of the QER status of the receipts for services during the first five years; only those under the renewal contract would be affected.<sup>40</sup>

In determining receipts from related and subsidiary services, receipts for parts furnished are not taken into account, and the proposed regulations refer treatment of such parts to the rules relating to sales of export property.<sup>41</sup> It should be noted that the qualification of receipts from services as QER is determined separately from qualification of receipts from the sale or lease to which they relate. Services may fail to qualify

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36. Proposed 1.993-1 (d) (4) (i).

37. Proposed 1.993-1 (d) (4) (ii).

38. Proposed 1.993-1 (d) (4) (iii).

39. Proposed 1.993-1 (d) (4) (iv).

40. *Id.*

41. Proposed 1.993-1 (d) (4) (v).

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as related and subsidiary, but the sale or lease to which they relate may still qualify as producing QER.

Receipts from the sale of QEA of the DISC produce QER if there is a gain on such sale.<sup>42</sup> The proposed regulations do not appear to limit the amount of the receipts treated as QER to the amount of the gain, but do provide that losses on such sales shall not be taken into account. Thus, for example, if a DISC sold one item of QEA with a basis of 100 for 50, and another with a basis of 100 for 150, the QER of the DISC would be 200, the sum of the receipts from the sales undiminished by the loss. Although the proposed regulations are silent on these points, it would seem that the deduction under section 1202 would not reduce QER, but that cost of sales would be taken into account as a reduction of the proceeds, and thus as a reduction of QER.

QER also includes taxable dividends from "related foreign export corporations", and amounts treated as distributed under section 951 of the Code, but only with respect to such related foreign export corporations.<sup>43</sup> QEA include certain debt obligations, notably producer's loans and certain trade receivables, and interest payments on such QEA are treated as QER (whether actually paid or treated as paid under section 1232 or 483).<sup>44</sup>

As with related and subsidiary services, the proposed regulations attempt to define engineering and architectural services to limit their allowability.<sup>45</sup> Generally, the proposed regulations appear to draw a line between selling technology apart from the actual personal services of the engineer or architect, and performing personal services which require knowledge of technology. The former, generally, are not productive of QER, while the latter are. Thus, as in the proposed regulations, feasibility studies for proposed foreign construction projects produce QER, but instructions for the application of technology to the manufacture of a product apparently would not produce QER. Perhaps the policy here is to limit the export of American technology under the shelter of the DISC rules, so as to reduce foreign competition with American manufacturing. Specifically excluded are engineering services related to exploration for minerals, though it is not clear how this limitation relates to the specific approval of feasibility studies. For example, if one of the considerations in determining whether exploration for minerals in a particular location was feasibility of constructing transportation and processing facilities at such location, would the receipts from the feasibility study be QER, if there was no separation of

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42. Proposed 1.993-1 (e).

43. Proposed 1.993-1 (f).

44. Proposed 1.993-1 (g).

45. Proposed 1.993-1 (h).

charges for such services and for advice directly about the possibility of profitable mineral deposits at the site?

Services relating to construction projects which are not qualified as engineering or architectural under the proposed regulations must qualify, if at all, as related and subsidiary to a sale or lease of export property.<sup>46</sup> Here the 50 percent rule for qualification of services as subsidiary would seem to permit some QER from services, but not enough to constitute an end run around the limitation of services generally.

As with related and subsidiary services, engineering and architectural services must be furnished by the DISC.<sup>47</sup> The proposed regulations do not make clear the required role of the DISC in a contract for the performance of such services where they are to be performed by a person other than the DISC, but generally it appears the DISC must participate to some extent in the arrangements before the services are actually performed.

Receipts for managerial services performed by the DISC for other unrelated DISCs are QER, but only if the DISC performing the services receives at least 50 percent of its total QER from sales or leases of export property and related and subsidiary services.<sup>48</sup> Thus, a DISC which received more than 50 percent of its total receipts from performance of managerial services for other DISCs would fail the 95 percent QER test, and would be disqualified unless it was able to make deficiency distributions. A DISC that received more than 50 percent of its total gross receipts from the performance of architectural or engineering services would also not realize QER from receipts for performance of managerial services for other DISCs.<sup>49</sup> If the 50 percent test is satisfied, the DISC may contract with another person for performance of such managerial services, or may act as a commission agent for the principal performing the services.<sup>50</sup>

To produce QER, managerial services must be performed for an unrelated DISC which derives QER from sales and leases of export property or related and subsidiary services.<sup>51</sup> It is not clear, however, what portion of the total receipts of the DISC for which the services are performed must be such QER. Managerial services must relate to the operations of the second DISC, but may not be legal, accounting, scientific, or technical. It is not clear whether the elimination of legal,

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46. Proposed 1.993-1 (h) (4).

47. Proposed 1.993-1 (h) (1).

48. Proposed 1.993-1 (i).

49. This is so because the 50 percent, under the test, does not include architectural and engineering services. See proposed 1.993-1 (i) (1).

50. *Id.*

51. Proposed 1.993-1 (i) (2).

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accounting etc. services is intended to be illustrative, or that these items would be productive of QER but for being expressly listed.

The DISC for which managerial services are performed must be qualified at the time the services are performed but need not be qualified as a DISC at the time payment is made.<sup>52</sup> Thus, for example, if services are performed in taxable year one of the DISC for which services are performed but such services are not paid for until year two of such DISC, and for year two such DISC does not qualify, the receipts could be QER to the recipient DISC. Proof that the DISC for which the services are performed qualifies generally requires a copy of its DISC election, and a statement that the election was filed. The DISC performing the services must have reasonable belief that the DISC for which the services are performed will qualify for the year of performance.<sup>53</sup>

Certain kinds of receipts are expressly excluded from QER treatment. These include receipts for sale or lease of property which is destined for ultimate use in the United States, sales of property which are subsidized by the United States Government, sales or leases of property for use by the United States, receipts from DISCs which are members of the controlled group that includes the DISC, and receipts from services which are related and subsidiary to a sale or lease the receipts from which are excluded from QER treatment.<sup>54</sup>

A most important exclusion is that for receipts from a commonly controlled DISC. Apparently there are two reasons why such receipts are excluded, to avoid a potential simultaneous equation (one where two variables are defined in terms of each other), and to prevent possible increase in the portion of the ultimate selling price to a foreign purchaser which can be sheltered under the DISC rules. The problem may be set forth by considering a case where DISC one purchases property from a related person (in a transaction subject to the pricing rules of section 994) and sells it to related DISC two, which in turn sells the property to a foreign purchaser. Under the pricing rules of section 994, the price paid by the second DISC to the first is determined with reference to the price the second DISC receives upon resale, and the price the first DISC pays its related seller is determined with reference to the price it receives upon resale. But in determining the price the second DISC pays the first, the cost of the property to the first DISC must be taken into account as a cost of the property, and thus the price paid by the second DISC is defined in terms, in part, of the price paid by the first DISC to its related seller, which price in turn is defined in terms of the price received by the

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52. Proposed 1.993-1 (i) (3).

53. *Id.*

54. Proposed 1.993-1 (j).

first DISC on its sale to the second. Even if Treasury wanted to take on the algebra, permitting sales by one related DISC to another to produce QER would shelter an enlarged portion of export income.

Presumably a sale by one related DISC to another would be subject to the special pricing rules of section 994. Under these rules a substantial portion of the receipts from an export sale is allowed to be realized as income by the selling DISC. Thus, even if the simultaneous equation is solved and some price between the first DISC and its related seller arrived at, this price will be less than it would have been if the first DISC itself had sold the property to the foreign purchaser. This is so because the second DISC will be entitled to a share of the overall profit realized (revenue less total costs of the two DISCs and the related seller of the first DISC) under the section 994 rules, thus, there will be less total profit to share under section 994 between the first DISC and its related seller.

For purposes of this rule, a member of the controlled group is a person that has the relationship described in section 1563(a) with respect to the DISC, but 50 percent is substituted for 80 percent wherever it appears in section 1563(a).<sup>55</sup>

Failure to satisfy the 95 percent QER test does not automatically mean that the DISC is disqualified for the year. Under section 992 certain distributions are permitted which will remedy the failure of the test.<sup>56</sup>

In order to be entitled to make curative distributions after failing the 95 percent QER test, the DISC must establish that it had reasonable cause for both its failure of the 95 percent test, and for its failure to make the distribution to cure that failure sooner. Reasonable cause may be demonstrated in either of two ways, by showing actual reasonable grounds for the two failures, or by meeting certain "near miss" standards.<sup>57</sup>

Under proposed 1.992-3(c)(2) actual reasonable cause for failure to meet the 95 percent test and for failure to make an earlier distribution is established if the DISC can show actual circumstances it relied upon in good faith which either prevented it from qualifying, or prevented it from knowing sooner that it failed to qualify, or prevented it from making a distribution. For example, blocked foreign currency may have prevented the DISC from receiving receipts or from distributing

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55. Proposed 1.993-1 (k). The definition of "related supplier" for purposes of section 994, however, uses the control definition of section 482, and it is possible that some "related suppliers" might not be members of the controlled group of the DISC under proposed 1.993-1 (k).

56. Section 992 (c) and Reg. § 1.992-3.

57. Reg. § 1.992-3 (a).

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excess nonqualified receipts and thus may either have caused a failure of the 95 percent QER test, or have prevented an earlier distribution. Alternatively, the DISC may not have known until after an audit that a section 482 allocation of income from itself to the related supplier would be made by the Service, and thus that it did not meet the 95 percent QER test for the taxable year with respect to which the allocation is made. It is not clear whether the good faith requirement reaches back into the transactions which later give rise to disqualification. For example, it is not clear to what extent the DISC, in a case involving a section 482 allocation must show that its pricing (or other transaction giving rise to the allocation) was in good faith, or whether it must only show, in effect, that it thought it could get away with its pricing (or other transaction).

Whether or not there was actual reasonable cause for failure of the 95 percent test and for failure to make a distribution sooner, these will be deemed for reasonable cause if the curative distribution is made within 8 ½ months after the close of the taxable year for which there was failure, and the QER of the DISC made up 70 percent of its total receipts for the year (and also if the QEA were 70 percent of the total assets of the DISC; as will be seen later, distributions are allowed with respect to failure of both tests for the same year).<sup>58</sup>

If either version of reasonable cause can be satisfied, the DISC may cure its failure of the 95 percent QER test by making a pro rata distribution to its shareholders equal to all its "taxable income" from receipts which were not QER for the year. "Taxable income" for this purpose is the gross receipts of the DISC less the DISC's cost of goods sold (if any) and also less expenses definitely related, under section 861(b) and regulations 1.861-8, to such income. For this purpose, unlike other purposes of DISC which also make use of the section 861(b) rules, expenses not definitely related to any item of gross income are not apportioned among all items of gross income, and therefore in part to the non-QER income. "Taxable income" for this purpose may therefore be greater than it would be under the usual rules for DISC.<sup>59</sup>

With respect to the amount required to be distributed, the proposed regulations seem to overlook the effect of failure of a receipt to qualify as QER. As will be seen later in this paper, the special section 994 pricing rules apply only in the case of transactions giving rise to QER. Also, the special rules under proposed 1.993-3(1), which entitle the DISC to income even though its participation in a transaction is mini-

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58. Reg. § 1.992-3 (d).

59. Reg. § 1.992-3 (b).

mal, apply only when the transaction gives rise to QER. Thus, if the transaction did not give rise to QER, pricing would be subject to section 482 arm's length standards, and the DISC would be entitled to any income from a transaction only if it performed a function therein (*i.e.*, if it "earned" the income). Since the pricing usually will not be arm's length in the DISC setting, and the DISC will ordinarily perform no function, it is quite possible that failure of a particular receipt to qualify will cure, at least partly, the failure to meet the 95 percent QER test automatically because an allocation of income will be made to the controlling person of the DISC, thus reducing its gross receipts by the amount of such allocation, and increasing the fraction of total receipts which are QER. This would seem especially likely in the setting where the DISC acts as commission agent. In light of the above analysis, it would appear that the example in the proposed regulations is misleading and that the correct result would be an allocation of all commission income from the DISC to the domestic manufacturer principal.<sup>60</sup>

If non-QER transactions produce a loss, no distributions are required, and presumably a mere statement setting forth the relevant figures would suffice.<sup>61</sup> But, since costs not definitely related to any particular item of gross income are not apportioned among all items of gross income, it is possible that, as in the regulations, there will not be an actual full cost loss, but a gain, and thus a required distribution for qualification purposes (see (c) of the example).

A curative distribution must generally be made within 90 days after the Service notifies the DISC that it failed the 95 percent test. If the DISC resists the asserted liability, and goes to the Tax Court, distribution must be made within 30 days after final decision by the court. Interest must be paid to the Service if distribution is made more than 8 ½ months after the close of the taxable year for which the test was failed. Since 70 percent near-miss reasonable cause requires distribution within the same period, there would be no interest in such case. Such interest is 4½ percent of the amount required to be distributed for each year after the year for which the distribution is made. Since this amount is treated as interest for all purposes of the Code, the DISC may deduct it in determining its taxable income for the year of payment.<sup>62</sup>

#### QUALIFIED EXPORT ASSETS

Determined as of the end of the DISC's taxable year, its qualified export assets (hereinafter, QEA) must equal at least 95 percent of its

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60. See Reg. 1.992-3 (b) (2) (ii) (*Example (a)*).

61. Reg. § 1.992-3(b) (2) (ii) *Example (c)*.

62. Reg. § 1.992-3 (c) (3), (4).



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total assets. This determination is made by comparing the adjusted bases of the QEA with the adjusted bases of all assets held by the DISC. In general, QEA include export property, certain business assets, certain trade receivables, certain temporary investments, producer's loans, stock or securities or certain foreign corporations, Export-Import Bank obligations, certain financing obligations, and certain funds awaiting investment.<sup>63</sup>

Business assets which qualify as QEA generally are those used by the DISC in its business activities. The proposed regulations, however, carve out from QEA assets used by the DISC "as a lessor." It is not entirely clear whether this means assets leased by the DISC are excluded altogether, or that only those which do not produce QER are so excluded.<sup>64</sup> Receipts from leases by the DISC can produce two kinds of receipts, QER and non-QER. The dividing lines between the two kinds of receipts include several distinguishing features, but the relevant one here appears to be whether the asset leased qualifies as "export property", for the rules of the statute and proposed regulations relating to the definition of such property contain most of the elements which would be required for a lease of such property to give rise to QER.<sup>65</sup> Since export property is specifically included in QEA by another provision of the proposed regulations and by the statute,<sup>66</sup> it seems unlikely that proposed 1.993-2(c), in excluding property used by the DISC "as a lessor", is intended to exclude property which produces QER from a lease. Perhaps, then, proposed 1.993-2(c) is merely a cautionary provision, intended to warn the reader that the "business assets" category of QEA is not a back door through which lease property which does not qualify as export property may be slipped. If so a rather obscure way of saying so has been chosen.

To qualify as QEA business assets must be used "primarily" in connection with transactions which produce QER. Assets used in connection with activities forbidden to DISC's, manufacturing or extraction of minerals, for example, are not QEA.<sup>67</sup>

Proposed 1.993-2(c)(1) also includes in QEA business assets used in connection with storage, handling, transportation, packaging, assembly, or servicing of export property.<sup>68</sup> Presumably this is intended to include property which relates to the kinds of receipts a DISC can realize as QER under the sale, lease, and related and subsidiary services

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63. Section 993 (b) and proposed 1.993-2 (a).

64. Proposed 1.993-2 (c).

65. See section 993 (c) and proposed 1.993-3.

66. Section 993 (b) (1) and proposed 1.993-2 (a) (1).

67. Proposed 1.993-2 (c) (flush language preceding (1), and following (2)).

68. The language comes almost verbatim from section 993 (b) (2) and the Senate Report, p. 99.

categories. It is possible however, that the language is too inclusive, and that it may include property used by the DISC in connection with transactions which do not produce QER. The ambiguity arises in the first instance from the statutory language the regulations parrot. The language of the statute and the proposed regulations relates the property to the production of QER, but in the statute it is unclear whether the relationship applies both to property used in connection with sales, leases, etc. and property used in connection with engineering and architectural, and managerial services, or the relationship must exist only between the property and QER in the case of managerial services. In the proposed regulations the ambiguity is cleared up, by semantically separating the categories to which property must relate, but the order of the wording in the statute is retained, with the result that the reference to relationship between QER and transactions to which the property relates only appears in proposed 1.993-2(c)(2), and therefore only requires QER from the described services, and not from sales, leases, etc. to which property relates. Since the proposed regulations merely carry over the language of the statute, the ambiguity still seems present, despite the fact that it does not arise under the structural rearrangement of the language in the proposed regulations, because it is not clear whether the proposed regulations are intended to resolve the statutory ambiguity (since they merely carry over the language).

It is the opinion of the author of this paper that the intention of the statutory draftsmen was to exclude from QEA property used in connection with a sale or lease of export property which does not produce QER, and that the proposed regulations should be amended either by changing the structure of proposed 1.993-2(c) to include a general requirement applicable to both proposed 1.993-2(c)(1) and (2) that QER be realized from the transaction to which the property relates (for example, by including such a requirement in the flush language following (c)(2)), or by including such requirement in proposed 1.993-2(c)(1) (for example, by adding at the end of (c)(1), after "export property", "provided such transactions or activities produce [or further the production(?) of qualified export receipts]").

Trade receivables are QEA if they arose from a transaction which gave rise to QER of the DISC (and of no other DISC) that holds the obligation. In most cases trade receivables will represent obligations of foreign purchasers for the goods sold or leased, or for services performed. Such obligations may be acquired by the DISC directly from the foreign purchaser, lessee, etc., or from the related person with which the DISC engaged in the transaction. It should be noted that the trade receivable need not relate to a transaction in which the DISC acted as principal, indeed, it would seem that this provision is of most benefit

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where the DISC acted as commission agent and acquires the obligation of the foreign purchaser to the related person for whom the DISC acted. This is so because the proposed regulations seem to limit "trade receivable" status for obligations owed by a third party to the DISC's related person to cases where the DISC acted as commission agent for such related person. Thus, where the property is sold by the related person to the DISC and then resold to the foreign purchaser as principal, it would appear that the amount by which the working capital of the related person could be increased over the usual proceeds of such a sale would be the excessive temporary price which could be paid to the related person by the DISC under the special section 994 pricing rules.<sup>69</sup>

QER must have arisen from the transaction which gave rise to the obligation, thus a trade receivable must relate to a transaction in which the DISC participated, since only a DISC can realize QER (and the transaction must be one in which no other DISC realized QER, so only the DISC holding the trade obligation may have been such a participant).<sup>70</sup>

Under section 994, the related person of the DISC which engages in a transaction subject to the special pricing rules need not immediately pay the DISC its entire share of the income from export. Where the DISC participated in such a transaction as commission agent for the related person, proposed 1.993-2(d)(2) imposes somewhat stringent requirements if the obligation of the related person for the DISC's commission is to be QEA in the hands of the DISC. Generally, such obligations must be payable and paid within 60 days after the close of the taxable year to which they relate to so qualify. Where the DISC acts as a principal in a section 994 transaction (*e.g.*, buys from the related person and sells to the foreign purchaser), the obligation of the related person for the DISC's share of the profit is not a trade receivable under proposed 1.993-2(d)(3).

Temporary investments such as demand deposits and obligations with less than one year to maturity are QEA if they are "reasonably necessary to meet . . . requirements for working capital" of the DISC. Obligations of members of the controlled group of the DISC may not qualify as QEA under this provision. The "reasonably necessary" working capital of the DISC, generally, is the amount of cash and cash equivalents necessary to repay obligations of the DISC which will mature currently, and to finance the normal business operations of the DISC. If a temporary investment also qualifies as QEA under some other provision (for example, some trade receivables might be treated as

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69. Proposed 1.993-2 (d) (1).

70. *Id.*

temporary investments) it is taken into account in determining whether the temporary investments exceed reasonable working capital needs, but even if such temporary investments exceed working capital needs, the otherwise qualified items will not be disqualified as QEA.<sup>71</sup>

Stock or securities of related foreign export corporations (as defined in proposed 1.993-5) are QEA. "Stock or securities" has the same meaning for purposes of section 993 as for section 351. Securities for this purpose do not include obligations repaid during the taxable year of the DISC after the year in which they were issued to, or acquired by, the DISC unless the DISC satisfies the District Director that such obligations were not issued to avoid tax, and were issued for "bona-fide" business purposes.<sup>72</sup>

Export-Import Bank obligations and Foreign Credit Insurance Association obligations are QEA whether issued, guaranteed, insured, or reinsured by such organizations. The DISC may acquire such obligations from the Bank or the Association directly, or from a buyer or seller who participated in a transaction giving rise to the obligation (or from a member of the controlled group which includes such buyer or seller). An obligation will be treated as having been acquired from the Bank or Association directly by the DISC if it is acquired from any person within 90 days after any part of the issue of a series of obligations which includes the obligation so acquired. Thus, for example, if a series of bonds is issued over a period of several months, the DISC must acquire such in the after market within 90 days of the time the first bond was issued, but, of course, it may acquire one of the bonds from the Bank or Association directly at any time.<sup>73</sup>

Obligations of the Bank or Association acquired after November 3, 1972, will qualify as QEA under proposed 1.993-2(h) only to the extent the total adjusted bases of such obligations (that is, those acquired after such date) does not exceed the accumulated DISC income less the outstanding producer's loans of the DISC. This provision apparently is Treasury's response to assertions that, while financial institutions may not qualify as DISCs (under section 993(f)(3)), subsidiaries of such institutions may. The theory of the provision seems to be that investments in Export-Import Bank and Association obligations should be encouraged only to the extent that they are investments of operating income of a DISC that engages in export transactions. The mechanics of the provision would preclude DISC qualification for a corporation that did nothing but invested in such obligations because its accumulated DISC income would never be sufficient to qualify a large

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71. Proposed 1.993-2 (e) (1), (4).

72. Proposed 1.993-2 (g).

73. Proposed 1.993-2 (h) (1).

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enough portion of the obligations as QEA to meet the 95 percent test. The subtraction of producer's loans from accumulated DISC income would seem to be directed to the possibility that the accumulated DISC income requirement could be bypassed by contribution of large sums to the capital of the DISC, which in turn would be loaned to United States manufacturers as producer's loans. Since producer's loans are QEA, it would be possible to put some Bank obligations in the DISC if the earnings on such obligations plus the amount of the producer's loans was 95 percent of the total assets of the DISC, if DISC income alone was the test.<sup>74</sup>

"Financing obligations", obligations of a corporation that "solely" issues obligations guaranteed by the Export-Import Bank, are QEA, but they are subject to a limitation similar to that applicable to Export-Import Bank obligations. The total of such financing obligations plus the Bank and Association obligations may not exceed accumulated DISC income less producer's loans.<sup>75</sup>

If temporary investments of the DISC exceed reasonable working capital needs, they may nonetheless qualify as QEA if they fall within the "funds awaiting investment" category. In order to so qualify, such investments must be bank deposits in the United States as of the end of the taxable year of the DISC, and at the end of the sixth, seventh, and eighth months after the close of such taxable year, 95 percent of all assets of the DISC must be QEA. This test does not involve tracing, is purely mechanical, and either all such "funds awaiting investment" or none of them qualify.<sup>76</sup>

As with QER, if the DISC fails the 95 percent QEA test it is permitted to make distributions after the end of the failure year to cure the failure. To be entitled to make such a curative distribution, the DISC, as with QER, must establish "reasonable cause" both for its failure to meet the test and for its failure to make an earlier curative distribution. Also as with QER these may be established in two ways: the DISC may show actual reasonable grounds why its failure was reasonable, or it may meet a mechanical 70 percent test.<sup>77</sup>

The 70 percent test for QEA failure requires the DISC to demonstrate that 70 percent of its total assets were QEA at the end of each month of the year for which it failed the 95 percent test. If reasonable cause is satisfied under either of these options, the required curative distribution is the fair market value of all assets held by the DISC on the

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74. Proposed 1.993-2 (h) (2).

75. Proposed 1.993-2 (i).

76. Proposed 1.993-2 (j).

77. Reg. § 1.992-3.

last day of the year which were not QEA.<sup>78</sup>

As with curative distributions of QER, a distribution must be made within eight and one-half months after the end of the failure year where reasonable cause is established under the 70 percent rule. Interest must be paid to the Service if actual reasonable cause is satisfied, and actual reasonable cause distributions must be made within 90 days after notification of failure of the 95 percent test by the Service. If the DISC is not aware of failure to meet the 95 percent test for several years, it need make a distribution with respect to a particular non-QEA asset only once. For example, if an asset does not qualify as QEA and is retained for several years, even though it might be a sufficiently large portion of total assets to cause failure for each year, an amount equal to its fair market value need only be distributed once to cure (or be part of a curative distribution) failure for each such year.<sup>79</sup>

Qualifying distributions are also permitted where both the 95 percent QER and 95 percent QEA test are not satisfied for the same year. In such case, the required distribution is the sum of the amounts required to be distributed for each.<sup>80</sup>

In determining whether the 70 percent reasonable cause is established for failure of the 95 percent QEA test, under proposed 1.993-2(j)(3) a DISC's money, demand deposits, etc. which were in excess of "reasonable working capital needs" for any of the months tested (and thus failed to qualify as QEA under the "temporary investments" category) will be treated as QEA under the "funds awaiting investment" category if either (a) on the last days of the sixth, seventh, and eighth months after the failure year 95 percent of the DISC's assets were QEA, or (b) as of the end of the year of failure the DISC's cash and cash equivalents were not in excess of its "reasonable working capital needs".

### EXPORT PROPERTY

In general, export property is defined as property (whether or not held by a DISC) which was manufactured, produced, extracted, etc. in the United States by a person other than a DISC, is held for sale or lease to non-United States persons, has not more than 50 percent foreign content, is not sold or leased by any person to a Western Hemisphere Trade Corporation (hereinafter, WHTC) which is a related person of the seller or lessor.<sup>81</sup>

"Services" must be distinguished from "property" in determining export property qualification. Generally, it would appear the proposed

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78. *Id.*

79. Reg. § 1.992-3 (b) (3) (ii).

80. Reg. § 1.992-3(b) (4).

81. Section 993 (c) and proposed 1.993-3 (a).

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regulations attempt to draw a line between categories similar to the line between engineering services and marketing technical knowhow under proposed 1.993-1(h)(3).<sup>82</sup> Thus, if a product which requires some special skills (a map, in the example in the proposed regulations) is custom made for the foreign person, the product will be considered "services", rather than "property." But if the product, though requiring technical skills to make, is produced to be held in inventory, and not produced for a particular person, it will be considered "property" and may qualify as export property. As with engineering services, it may be anticipated there will be many cases near the line between "good" and "bad" items.

Property will be considered of United States manufacture if it is produced by a person which is not a DISC, and in the United States. If the manufacturer was not a DISC at the time of manufacture, but is at the time the property is sold, it will not be export property. Property partly manufactured in the United States and further manufactured by the same person abroad will also not be export property. It is not clear whether a *de minimis* approach will be taken here. For example, if an electrical appliance is manufactured in the United States but a voltage converter is installed by the manufacturer overseas, would the property fail to qualify? Under the proposed regulations it would appear so. Foreign manufacture is forbidden only to the DISC's seller. Thus, for example, if A is a domestic manufacturer and B is a foreign purchaser, A can partly manufacture property, sell it to the DISC for resale to B, and B can further manufacture the property abroad. In such a case, the property could qualify as export property, and the DISC could realize QER from the transaction.<sup>83</sup>

Since export property must be manufactured by a person other than the DISC, a definition of "manufacture" is provided in proposed 1.993-3(c)(2). Under the proposed regulations a person will be considered to have manufactured property if he actually manufactured property, or if he contracted with another person for the manufacture of such property.<sup>84</sup> The location of the line between "contracting" with another person for the manufacture of property, and purchasing from inventory of the manufacturer is as hazy as the line between "property" and "services". Thus, for example, the controlling shareholder of the DISC may be a domestic manufacturer, and may very well know what property the DISC will be able to sell abroad in the coming year. If the controlling shareholder specifically manufactures for DISC sales on the basis of a tentative purchase agreement from the DISC, does this

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82. Proposed 1.993-3 (b).

83. Proposed 1.993-3 (c).

84. Proposed 1.993-3 (c) (2).

constitute “contracting”? And if the product is a highly complicated piece of machinery for which there are a very few foreign customers, could the property in fact be “services”? And would the result be any different if the controlling shareholder under these circumstances arranges for another manufacturer to produce the property (by pushing production back one step further from the DISC, in other words, would there be less chance the DISC would be treated as having “contracted” and therefore “manufactured”)? In this complicated web at least one rule is reasonably clear: manufacturing does not include packaging and assembly, which are generally defined to include the addition of less than 20 percent to the value of the property.<sup>85</sup>

Export property must be held for the “primary purpose” of sale or lease in an export transaction for use outside the United States. Three tests must be satisfied to meet the “primary purpose” requirement: a destination test, a “proof of compliance” test, and a “non-United States use” test.<sup>86</sup>

Unlike the WHTC provisions, property sold through a DISC must meet a “destination” test to produce QER.<sup>87</sup> Generally, where there is a sale directly to the foreign purchaser, the destination test concentrates on the mode or place of delivery. Thus, delivery to the foreign purchaser from the DISC’s foreign warehouse, delivery to a carrier for delivery to the buyer abroad, or delivery to the foreign purchaser in the United States where such purchaser transports the property abroad on his own ship, would satisfy the destination test. The place of the passage of title, or shift of the risk of loss are irrelevant under the destination test. Delivery to an unrelated DISC, even though such delivery is made in the United States will satisfy the test.<sup>88</sup>

If property was leased before the foreign sale or lease in question, delivery will be considered to have taken place abroad, under the new lease or sale, if the prior lease expired by its own terms or by action of the lessee, or if the former lessor was not a related person of the DISC and terminated the lease. For example, if property was leased abroad by a controlling shareholder of a DISC before the passage of the DISC provisions, such old lease may not be terminated and a new lease substituted with the DISC a party to take advantage of the DISC provisions unless the lessee terminates the lease or it expires of its own terms.<sup>89</sup>

Proof of compliance is demonstrated generally by production of

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85. Proposed 1.993 (c) (2)(iv).

86. Proposed 1.993-3 (d) (1).

87. See, e.g., Regulations 1.921-1 (b) *Example* (1).

88. Proposed 1.993-3 (d) (2).

89. Proposed 1.993-3 (d) (2) (vi).



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documents relating to the export transaction, such as bills of lading and receipts for transportation. In this area the proposed regulations seem to depart from the language of the Senate Report. Under that report, a DISC selling to an unrelated person need only satisfy a "knew or should have known" test with respect to foreign delivery and use of the property.<sup>90</sup> Under the proposed regulations, however, the DISC is required to demonstrate that property was delivered abroad (or otherwise meets the foreign destination test) and that there was not "further use, manufacture, assembly, or other processing within the United States."<sup>91</sup> The difference in standards may be the result of a notion that the two requirements are separate, compliance-proving being one kind of act, and foreign use being another. But the compliance-proving is with reference to the place of use, so the two overlap.

The "non-United States use" test is satisfied, generally, if the property is actually used outside the United States, if in a sale to an unrelated person there is no reason to believe it will be used in the United States, or in the case of a sale to a related person of the DISC if the property is not used in the United States. Thus, actual knowledge of the place of use is not required where there is a sale to an unrelated person, and a "reasonable man" standard is applied, but in sales to related persons of the DISC knowledge is attributed to the DISC whether or not a reasonable man would have known of the United States use.<sup>92</sup>

Because property sold by a DISC may be incorporated into other property, two special rules are provided. If the DISC sells property to a related person, and the property is incorporated into another product which is used in the United States, the property sold by the DISC will be considered used in the United States. In a sale to an unrelated person, however, if the property sold by the DISC is incorporated into other property by such buyer, and the property sold by the DISC is less than 20 percent of the value of the second property, the property sold by the DISC will not be considered used in the United States. For example, if the DISC sells a component to a foreign manufacturer, and the foreign manufacturer sells some of his output of the product which includes that component to United States purchasers, the DISC will not be considered to know (or should have known) that the component will be used in the United States, if the value of the component is less than 20 percent of the total value of the second product. This is a most curious rule, for it seems to focus on the second product to the exclusion of the first. In other words, while the property sold by the DISC may be only 20 percent by value of the property sold by the foreign manufacturer for

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90. Senate Report, pp. 98-99.

91. Proposed 1.993-3 (d) (3).

92. Proposed 1.993-3 (d) (4).

United States use, it is 100 percent of the property sold by the DISC, and that is the usual (and proper) focus of the DISC provisions. Perhaps the problem here is that there is too much focus in the regulations on "property" and too little on "use."<sup>93</sup>

It is not clear how the component exception relates to the agreement or understanding rule of the proposed regulations. Property is for United States use, and thus not export property, if there is an "agreement or understanding" that the property will be used in the United States. The component exception, however, applies only to the "reasonable man" standard. Thus, literally applied, the proposed regulations seem to say that a reasonable man, in the component situation, would not have reason to think the component was for United States use if it was less than 20 percent of the value of a product sold to United States purchasers by the foreign buyer of the component. But would there not be an "understanding" in such case?

It might appear, from its use in conjunction with "agreement" that the term "understanding" was intended to mean some arrangement between the DISC and its foreign purchaser, but the proposed regulations describe "agreements or understandings" as including situations where the purchaser tells the DISC it intends to sell some of the property for use in the United States.<sup>94</sup> Thus, it would seem that many cases otherwise covered by the component exception will be excluded from export property status by the "agreement or understanding" rule, especially if the DISC has actual knowledge of potential United States use.

Property need not be used exclusively outside the United States to qualify as export property, only "predominate use outside the U.S.," is required. Thus, in the case of an airplane, use outside the United States 50 percent of the time, or for 50 percent of the total miles traveled will suffice.<sup>95</sup> It would also appear, under proposed 1.993-3(d)(4)(iii), that the initial use of property sold by a DISC outside the United States for 365 days will be sufficient, though this presumably would not be the case where the DISC knew that the property was to be used in the United States after such period (this, however, is not clear from the proposed regulations).

The permitted foreign content of export property is limited, generally, to 50 percent of its fair market value. And, once property has been sold to a foreign purchaser, it becomes foreign property. Thus, for example, if property is manufactured in the United States by A, sold to foreign purchaser B, who sells such property to the DISC's controlling shareholder C, who sells to the DISC for resale in an export transaction,

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93. Proposed 1.993-3 (d) (4) (ii) (c).

94. Proposed 1.993-3 (d) (4) (ii) (flush language following (c)).

95. Proposed 1.993-3 (d) (4) (vi).

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the foreign content of the property would be 100 percent, and the property would not qualify as export property. In determining the portion of the fair market value of the property sold by the DISC its fair market value is used, not including interest, finance or similar charges. The foreign content portion is determined under the tariff valuation of the imported property, as evidenced by customs invoices.<sup>96</sup>

Among items excluded from export property are property leased to a related person unless such lessee in turn leases to an unrelated third person who uses the property predominantly outside the United States, certain intangible property such as copyrights, and property determined by the President to be in short supply.<sup>97</sup>

### PRODUCER'S LOANS

Producer's loans generally are loans from a DISC's accumulated DISC income to a United States manufacturer of export property. Such loans are an important part of the DISC provisions because they are one of the two ways a DISC may distribute its tax-deferred income to its controlling shareholder without ending the deferral on such income, or threatening the qualification of the DISC. While there is no tracing of the funds so loaned, the amount a DISC can loan in this form is generally limited to the amount of the accumulated income of the DISC (which has not been taxed to the DISC's shareholders), and is limited by the proportion of the borrower's export sales to total sales. The borrower in such a loan need not be a related person of the DISC, though it is likely such borrower usually will be the controlling shareholder. The limitation on producer's loans applies only as of the time the loan is made, thus, if accumulated DISC income declines after the loan is made it will still qualify as a producer's loan.<sup>98</sup>

The total amount of producer's loans by the DISC may not exceed the total accumulated DISC income of the lender-DISC as of the beginning of the month in which the loan is made. But the month-by-month qualification is deemed met if producer's loans as of the end of the DISC's taxable year do not exceed its accumulated DISC income at that time. Deemed distributions for increases in foreign investment attributable to producer's loans under section 995(b)(1)(E) are not taken into account in determining accumulated DISC income for this purpose, but actual distributions are taken into account.<sup>99</sup>

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96. Proposed 1.993-3 (e).

97. Proposed 1.993-3 (f).

98. Section 993 (d) and proposed 1.993-4. The other way the DISC can distribute its tax-deferred income is through the purchase of trade receivables of its controlling shareholder. See section 993 (b) (3) and proposed 1.993-1 (d).

99. Proposed 1.993-4 (a) (3).

Producer's loans must be in writing, and have a stated maturity of not more than five years, determined from the time the loan is made. For example, if a loan was originally for three years and had two and one-half years remaining to maturity, and if such loan is extended for three years, it will not qualify as a producer's loan because the period from the date of extension to the new date of maturity is greater than five years. In such case the loan could have qualified as of the date originally made, but would be considered terminated at the time of extension.<sup>100</sup>

The borrower must be a United States manufacturer, producer, grower, or extractor of export property. Thus, some property so manufactured, etc., must be sold or leased in export transactions through a DISC since export property is so defined in section 993(c)(1). There are no provisions in the proposed regulations, however, which define the extent of such activities required, or the proportion of total property which must be export property. There is no requirement that money loaned by a DISC as a producer's loan be traced to domestic manufacturing assets (or assets used in the other described activities).<sup>101</sup> The total producer's loans to a particular borrower (from all DISCs) may not exceed the borrower's export related assets multiplied by a source of receipts fraction.<sup>102</sup> The borrower's export related assets are the total of its: (a) United States located manufacturing, producing, etc. assets, (b) inventory property, and (c) research and development expenditures within the meaning of section 174.<sup>103</sup>

United States manufacturing, producing, growing, and extracting assets are taken into account at their adjusted bases as of the beginning of the taxable year of the loan. Thus, depreciation for the year of the loan does not reduce such amount. Supporting facilities such as warehouses and transportation equipment are included if they are used primarily to support manufacturing, etc., facilities.<sup>104</sup>

Inventory property is taken into account at the inventory valuation used for tax purposes by the borrower, includes property held for lease, and the beginning of the year of the loan value is used. It would appear that property leased is considered held for lease.<sup>105</sup>

Research and development expenditures are the aggregate of expenditures described in section 174 for taxable years of the borrower beginning after December 31, 1971 and ending before the year of the loan. No tracing of expenditures to export related assets, production, or

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100. Proposed 1.993-4 (a) (4).

101. Proposed 1.993-4 (a) (5).

102. Proposed 1.993-4 (b).

103. Proposed 1.993-4 (b) (2).

104. Proposed 1.993-4 (b) (2) (ii).

105. Proposed 1.993-4 (b) (2) (iii).

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transactions is required, and such amounts are taken into account even though they were previously taken into account for purposes of another producer's loan by a DISC. Such amounts include expenditures by a predecessor corporation carried over under section 381(a)(1) or (2).<sup>106</sup>

The source of receipts fraction applied to export related assets to determine the limit on loans to a particular borrower is the total gross receipts from sales or leases in the same period. Years beginning before January 1, 1972 are not taken into account. Export sales and leases, if the borrower so elects, may include all such transactions by members of the borrower's controlled group.<sup>107</sup>

Gross receipts in the denominator of the fraction are taken into account only for years when there are export sales included in the numerator. Thus, for example, if there were no export sales for 1974, the 1976 fraction would exclude that year altogether, and would include export receipts in the numerator, and total receipts in the denominator, only for 1973 and 1975.<sup>108</sup>

Where the borrower sells or leases property to a domestic related person which resells or leases the property, the receipts of the borrower, whether or not an election to include all sales by all members of the borrower's group is made, are the receipts realized by such related person from such property. For example, if A sells property to related person B, and B resells such property, the amount received by B would be the amount taken into account by A in determining its fraction (and not the amount B may have paid A for the property). It appears that this rule only applies to determination of the numerator of the fraction, because this rule appears only in proposed 1.993-4(b)(3)(1)(i), which relates only to the numerator. If an election is made to include all sales by related persons in both the numerator and denominator, presumably, in the example above, only receipts of B, and not those of A from B, would be taken into account, and the special rule discussed in the previous sentence for the numerator would, of course, be meaningless (because the two rules would overlap). If a very great proportion of the sales of the borrower were to related domestic selling entities (including DISCs) who resold in export transactions, and if no election was made to include all sales by controlled group members in both the numerator and denominator, it is possible that the fraction would have a numerator greater than its denominator. For example, if borrower A had two subsidiaries, B and C, and sold only to such subsidiaries, and if B and C paid A less than they received upon resale of the property, the

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106. Proposed 1.993-4 (b) (2) (iv).

107. Proposed 1.993-4 (b) (3).

108. Proposed 1.993-4 (b) (3) (ii).

numerator of the fraction for A would be the amount received for sales of the property by B and C, but apparently the amount for the denominator of the fraction would be the amount received for the property by A from B and C. Since B and C are assumed to make profits on their sales, the numerator of A's fraction would be greater than the denominator. The effect would apparently be magnified if B and C were DISCs, since DISC pricing rules under section 994 would give them a greater share of the income realized from sales than they would be entitled to under section 482. Even if the fraction was greater than one, it seems unlikely producer's loans would be allowed to exceed the actual amount of the export related assets.

Where the borrower does not have three years of sales or leases, so many as he has are included in the fraction. Because only years beginning after December 31, 1971 are taken into account, and because the fraction is determined with reference to the receipts for years before the year of the loan, a calendar year taxpayer would have no fraction, and thus could receive no producer's loans before calendar year 1973.<sup>109</sup>

Producer's loans to a borrower may not exceed the increase, during the year of the loan, of the amounts treated as export related assets. Such increase is determined by taking the value of such items at the beginning of the year of the loan and subtracting it from the value of such items at the end of the year of the loan. Since this determination is made year-by-year, research and development expenditures are only taken into account to the extent they are incurred during the year of the loan, and are not cumulated.<sup>110</sup>

The effect of the limitation of producer's loans during a year to the increase in export related assets is to require, if producer's loans are to be a continuing way of extracting tax-deferred income from the DISC, a continual increase in United States investment in plant and equipment. Merely to stay even in the amount of export related assets, the borrower must add sufficient assets to offset the decrease in the adjusted bases of assets for depreciation. And there is a multiplier effect, too, for depreciation on new assets will increase the amount which must be offset each year before any positive increase overall can be shown. In view of this, it seems likely that producer's loans will not fully serve their intended purpose, serving as a carrot to induce United States investment in plant and equipment, since trade receivables will accomplish the same ends for the DISC and its controlling shareholder without the "stick" aspects of producer's loans.

Where the amount of producer's loans for a year exceeds the increase

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109. Proposed 1.993-4 (b) (3) (iii).

110. Proposed 1.993-4 (c).

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in export related assets for that year, loans are disqualified in reverse order; that is, loans are treated as qualified in the order in which they were made during the year until the limit is reached. In order to establish that a loan is a producer's loan, a DISC must obtain an audited statement from the borrower that loans qualify under the above tests.<sup>111</sup>

A further limitation on producer's loans is imposed to the extent foreign investment of the controlled group increases. This limitation is in the form of automatic deemed distributions of DISC income.<sup>112</sup>

### RELATED FOREIGN EXPORT CORPORATION

Three classes of corporations are treated as related foreign export corporations of a DISC, with the result that their stock and securities are treated as QEA, and payments on such instruments are treated as QER. The three classes are Foreign International Sales Corporations (hereinafter, FISC), Real Property Holding Companies (hereinafter RPHC), and Associated Foreign Corporations.<sup>113</sup>

A FISC is a corporation of which the DISC owns 50 percent of the total combined voting power, 95 percent of the gross receipts of which are QER (determined as though the corporation was a DISC), and 95 percent of the assets of which are QEA (determined as though the corporation was a DISC). Total combined voting power is determined as in regulations 1.957-1(b), and the accounting principles used in making relevant determinations are those of regulations 1.964-1 (relating to earnings and profits of a controlled foreign corporation).<sup>114</sup>

A corporation is a RPHC if 50 percent of its voting power is owned by the DISC, and its "sole" function is holding foreign real property for the "exclusive" use of the DISC where the DISC is not permitted, under the laws of the country in which the property is located, to hold such property itself. Property leased to the DISC is not held "exclusively" for the use of the DISC if it is subleased by the DISC to a third party, except that a DISC which realizes 90 percent of its QER from commissions from a particular related person may sublease the property to that related person.<sup>115</sup>

A corporation is an Associated Foreign Corporation if a DISC and the members of its controlled group own less than 10 percent of the total combined voting power, and such ownership furthers the realization of QER by such DISC. A corporation may qualify if no stock is owned by the DISC and members of its group, under the proposed regulations,

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111. Proposed 1.993-4 (c) (3).

112. See section 995 (a) (1) (E), and (d).

113. Section 993 (e) and proposed 1.993-5.

114. Proposed 1.993-5 (b).

115. Proposed 1.993-5 (c).

if it can be demonstrated that ownership of securities furthers realization of QER. There appears to be no limitation on the percentage of the total securities which may be owned by the DISC and its group.<sup>116</sup>

Ownership of such stock or securities "furthers" the realization of QER by the DISC if it maintains the foreign corporation as a customer of the DISC or related person of the DISC, and the amount of the investment is reasonable in light of the receipts realized because of the relationship. Membership of the controlled group of the DISC does not include foreign persons for this purpose.<sup>117</sup>

#### THE PRICING RULES UNDER SECTION 944

At the heart of the DISC provisions are the special pricing rules of section 994. If there were no such rules, the usual arm's length standards of section 482 would apply to sales to a DISC by its related supplier, and in the usual case there would be no income in the DISC because the DISC would have performed no economic function with respect to the sale and resale (which ordinarily will be mere paper transactions). Thus, there would be no DISC income to defer, and no benefits to taxpayers setting up such corporations. To avoid this result, section 994 permits pricing which, without regard to the functions performed by the DISC, will permit substantial income to the DISC. This is accomplished by permitting the choice of either of two methods, the 4-percent gross receipts and the 50-50 combined taxable income methods, each of which is mechanical and generous.<sup>118</sup>

Under the 4-percent gross receipts method, the DISC is charged that price which will cause it to realize taxable income from the transaction equal to 4 percent of the gross receipts it realizes upon resale of the property, plus 10 percent of the export promotion expenses attributable to the transaction.<sup>119</sup>

Under the 50-50 combined taxable income method, the DISC is charged that price which will cause it to realize as taxable income one-half the combined taxable income of the DISC and related supplier from the transaction, plus 10 percent of the export promotion expenses attributable to the transaction.<sup>120</sup>

If they wish, the parties may also choose the section 482 method, which simply means that the price charged the DISC is subject to arm's length standards under section 482 and the regulations thereunder. It would seem that this method would never be chosen, and thus would be

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116. Proposed 1.993-5 (d).

117. Proposed 1.993-5 (d) (3).

118. *See generally*, section 994 (a) and Reg. § 1.994-1.

119. Section 994 (a) (1) and Reg. § 1.994-1 (c) (2).

120. Section 994 (a) (2) and Reg. § 1.994-1 (c) (3).



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useless, but as will be seen later herein this method may be quite useful, for example where sales are at a loss and the DISC performs some functions with respect to the transaction.<sup>121</sup>

At first glance it would seem from the language of section 994(a) that the method which produced the greatest taxable income to the DISC would have to be chosen. This, however, is not the case under the regulations, and the parties may choose any of the three methods, even though some other method would result in greater taxable income to the DISC. This could be quite useful in some cases. For example, if the related supplier had loss carry-forwards which expired in a year of sales to a DISC, and insufficient income from other sources to take full advantage of them, a method could be chosen which would put approximately enough income from export transactions in the related supplier to offset the losses. In short, this freedom in the choice of method permits considerably more flexibility than would be permitted under the usual rules of the Code.<sup>122</sup>

Since the provisions of section 994 so obviously parallel those of section 482 with respect to the kinds of transactions to which they apply (and, in large measure, in their details), it should be noted that a DISC clearly does not have to meet any significant tests of "substance" in order to be recognized as a separate entity from its shareholders. And it does not have to perform any particular economic functions with respect to a particular transaction to be entitled to receive a share of the income. This is not to say that the rules of section 482 are completely inapplicable; as will be seen later herein, it is entirely possible that a section 482 allocation of income or expenses could be made, and that it would have a substantial impact on the application of the special pricing methods.<sup>123</sup>

The choice of method for particular transactions is to be made by the related supplier. This seems merely to be a recognition that in most cases the DISC will be a mere paper entity, and generally a mere department of the related supplier.<sup>124</sup>

Under section 994(a) and 1.994-1(c), the special pricing rules are applicable only in the case of transactions between a "related supplier" (defined as a "person described in section 482" with respect to the DISC) and a DISC. This requirement is probably unnecessary since only a person related to a DISC would have an incentive to engage in a

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121. *Id.*

122. Section 994 (a) (3) and proposed 1.994-1 (c) (4). Section 994 (a) states "taxable income . . . shall be based upon a transfer price which would allow such DISC to derive taxable income attributable to such sale . . . in an amount which does not exceed the *greatest* of . . ." (emphasis added).

123. *Infra*, page 77.

124. See section 992 (a) (1) for the minimal requirements of substance for a DISC.

transaction with a DISC which would allow it a larger share of the income than usual, especially where the effect of the DISC provisions would be to shift the extra income allowed the DISC under the special pricing rules to the shareholders of the DISC, but it underscores the function of DISC, to permit a United States exporter to get special tax treatment of his export income, and the function of the separate incorporation requirement, to simplify record-keeping. One effect of requiring the DISC's seller to be a person described in section 482 with respect to the DISC would be generally to prevent shifting income from less than 50 percent commonly controlled entities to the DISC, and thus in a general way to keep a fairly high degree of overlap between the entities which are allowed to shift income into the DISC under the special pricing rules and those which will receive deemed distributions of income from the DISC.<sup>125</sup>

Transactions between a DISC and a person which is not a related supplier are subject to normal arm's length standards of section 482 as to whether the income from such transactions was "earned" by the DISC or by its controlling and commonly controlled parties. So, where a DISC is a mere department of the related supplier, it is likely that such income would be treated as income of the related supplier and not of the DISC, on the ground that the income was in fact "earned" by the related supplier. This, of course, would not be the case where the DISC had "substance" and performed meaningful functions in connection with the transaction.<sup>126</sup>

There is a curious lack of correlation between the definition of "related supplier" in section 994 and the definition of "controlled group" in section 993(a). The former is defined in terms of section 482, and the latter in terms of section 1563(a), which are similar but not identical. Thus, for example, the Service seems to take a fairly functional view of the term "control" in section 482, but the delineation of mechanical standards in section 1563(a) (which is modified by substituting 50 percent for 80 percent for purposes of the definition under section 993(a)(3)) would seem to limit the extent to which such an approach could be taken thereunder. Thus, it is possible that a person could be a related supplier of the DISC for purposes of the applicability of the section 994 pricing rules, but such person might not be a member of the same "controlled group" as the DISC. This could have some interesting effects. For example, under section 993(a)(2) (the flush language following (C)) receipts from another DISC which is a member of the controlled group of our DISC cannot be QER. This means that the pricing rules of section 994(a)(1) and (2)

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125. Proposed 1.994-1 (b).

126. See, e.g., *American Savings Bank*, 56 T.C. 828 (1971).

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cannot apply to such transactions, because they only apply to transactions which produce QER for our DISC. If, however, the other DISC could fit within the common control standard of section 482 but not the common control standard of section 1563(a) (with the 50 percent modification), the transaction could be subject to the special pricing rules, a result which was clearly not intended. Since the relevant tests are set forth in the statute, it is hard to see how Treasury could overcome this possible technical problem short of legislative correction. It is possible Treasury could exercise its authority under section 993(a)(2) to exclude the subject receipts, but it would seem the restrictive conditions on that authority under section 993(a)(2)(A), (B), and (C) would preclude any meaningful correction.

Under 1.994-1(a)(3)(ii), a transaction will be subject to the special pricing rules only if the related supplier "*singly engages in a transaction directly with the DISC*" (emphasis added). This language is apparently intended to preclude treatment of more than one related person of the DISC as a related supplier for purposes of computing transfer prices under section 994(a)(1) and (2). For example, assume corporation P owns 100 percent of the stock of corporation D, a DISC, and 50 percent of the stock of X. The other 50 percent of the stock of X is owned by corporation Y, and P and Y have an agreement to share the output of X. The subject rule would prevent P from making the section 994(a)(1) and (2) computations with respect to the relevant figures for itself and X together if it was desired to sell some of X's output (in excess of P's needs) abroad. The basic reason why the rule has this effect is because it is impossible to get the product out of X and into D without either being subject to the arm's length pricing rules of section 482, thus eliminating any substantial margin between the costs of D's related supplier (P) for the product and the foreign selling price, or forcing Y to permit a substantial portion of X's profit to be shifted to P (*i.e.*, a sale between X and D would be subject to the special pricing rules, but that would mean a large part of the profit X would normally earn on sales to P or Y would be shifted to D by the section 994 pricing rules and thus would end up benefitting P). In effect, as illustrated by the example in the regulations, the rule permits only the selling stage of a vertically integrated operation to shelter its income under DISC (though some manufacturing income would also be sheltered, if this is the stage at which the related supplier participates; but see the possible effects of marginal costing, which can have the effect of shifting income around within the controlled group).

Section 994 permits the special pricing rules to be applied only with respect to QER attributable to a transaction. The effect of this limitation could be quite significant where, for example, it is determined upon

audit that the foreign content test of section 993(c)(1)(C) was not met with respect to property sold through the DISC, that the property does not therefore qualify as export property, and that the receipts are not QER. The effect of this would be that the DISC might not meet the qualifying requirement of section 992(a)(1)(A) that 95 percent of the gross receipts are QER, and in any case, the transfer price of the property would be adjusted to the arm's length standards of section 482. A further possible effect could be that computations of other prices charged the DISC would have to be adjusted, even if they undoubtedly produced QER. For example, the determination of combined taxable income from a transaction is made with reference to the rules of section 861(b) and regulations 1.861-8 (proposed to be changed by a recent notice of proposed rule making). It is quite possible that expenses attributable to particular receipts might have been determined by use of the general allocating fraction of regulations 1.861-8(a) (and proposed 1.861-8(c)(2)) (*i.e.*, multiply not definitely related expenses by a fraction, the numerator of which is gross income from the particular transaction, the denominator of which is total gross income) and that the change in the amount of income allowed the DISC, and a possible allocation of expenses to a related party (to match income allocated to the related supplier?) would change the computation thereunder. This would have the effect of changing combined taxable income and the DISC's income from the QER producing transaction, thus requiring a recomputation of the section 994 transfer prices. The same effect could occur with respect to items of the related supplier selling the property which failed to qualify to the DISC, since its figures which go into the computation of combined taxable income are also determined with respect to the rules of section 861(b).

In order for the special pricing rules to apply the QER from the transaction must be of particular kinds. Under 1.994-1(b) only those transactions which give rise to QER described in section 993(a)(1)(A), (B), (C), (G), or (H) would be subject to the special pricing rules. Generally this is not a severe restriction, because the kinds of QER excluded would not normally be susceptible to the application of the pricing rules.

In what is undoubtedly a concession to simplicity and administrative feasibility, 1.994-1(b) further requires that the DISC and its related supplier engage in the same kind of transaction on their respective ends of the deal. For example, 1.994-1(b)(1) (and the flush language following (b)(5)) carve out the case where the related supplier sells property to the DISC, and the DISC leases the property abroad. If such a case was covered by the special section 994 pricing rules it would be necessary to provide several detailed rules. For example, it would be

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necessary to provide a rule for determining when the special pricing rules would be applied (*e.g.*, when would the DISC's gross receipts be realized under section 992(a)(1)? A lease of property could run for several years, and be subject to renewal), and also for the situation where the DISC did not qualify for each of the years of the lease (whether or not some sort of prepayment was constructed).

Assuming the requirements set forth above are met, the related supplier may select one of the three methods permitted. Both for purposes of the combined taxable income method itself, and for purposes of the rule precluding the application of the pricing methods so as to produce a loss to the related supplier, it is necessary to determine the "combined taxable income" from a transaction. In general this is determined, under 1.994-1(c)(6), in two steps: first the cost of goods sold of the related supplier (and of the DISC, if it has any) is subtracted from the receipts of the DISC from the transaction, second the deductible expenses of the DISC and related supplier attributable to such receipts are subtracted to yield combined taxable income. In applying this computation, where the DISC acts as commission agent the general rule of section 993(f) (that the gross receipts of the related supplier with respect to which the commission is allowed are the gross receipts of the DISC for purposes of the DISC provisions) applies. In determining costs attributable to particular receipts the rules of section 471 for inventory cost are applied. For determining the expenses attributable to receipts, the rules of regulations 1.861-8 (to be modified by the recent notice of proposed rule making) are applied.

While the computation under section 994 is shielded from section 482 allocations of income and expenses, this is not the case for the items which make up the computation, and items of expense would seem particularly vulnerable to allocations, since the DISC ordinarily will not perform much of a function in a transaction. Other possible allocations of income under section 482 would include the price charged by the DISC to its buyer (especially if the buyer is a related corporation in a low tax country), and prices paid by the related supplier for the product or a part thereof to a related person of the related supplier. Each of these allocations would have quite substantial effect on the section 994 computations, in the first case by reducing the receipts of the DISC, and thus combined taxable income as well, in the second by increasing costs of the related supplier attributable to the property, thus decreasing combined taxable income.

The section 482 method presents some particularly difficult questions. In particular, the regulations do not make it clear whether all the doctrines and rules of section 482, or only those consistent with the DISC provisions apply under section 994(a)(3). For example, a

possible argument for the Commissioner under section 482 is that the corporation lacks substance, or did not perform a function with respect to a particular transaction. Would these arguments apply as well when the section 482 method is chosen under section 994? If so, there would seem few profitable transactions which would permit the DISC any income under such method, since the DISC will usually be a mere department of the related supplier. It could be argued for the taxpayer that such doctrines of section 482 would make little sense as applied to DISCs, since lack of substance and failure to perform functions are acceptable throughout the DISC provisions, and therefore Congress must have intended some of section 482's thorns to be stripped off when it came into section 994(a)(3). In the absence of clarification in the regulations, however, probably the cautious approach of assuming all of section 482's rules and doctrines apply would be wise.

One of the more troublesome problems under section 482 is whether an allocation of income may be made before income has been realized from without the controlled group. This is often referred to (usually by those who object to such allocations) as the doctrine of creation of income—that section 482 permits the Commissioner only to allocate income, not to create it—and in a recent case involved a situation where the parent corporation transferred to its subsidiary certain houses which were unsalable, which the subsidiary held for rental. The Commissioner sought to allocate to the parent corporation the income which would have been realized had the houses been sold to an unrelated third party, but the court refused to countenance it.<sup>127</sup>

A similar situation arises under the special pricing rules of section 994. Mechanically, for the computational methods of section 994(a)(1) and (2) to operate, there must be some number which represents gross receipts from the export transaction. If export property is sold to the DISC in year one, but is not resold by the DISC until year two, unless there is considered to be no sale to the DISC for purposes of section 994 until year two, some special rule is required. This situation is dealt with in extraordinarily liberal fashion by 1.994-1(c)(5).

Under 1.994-1(c)(5), there are two transfer prices. The first of these is an initial payment by the DISC in the year of sale by the related supplier to the DISC. This price is the amount of the related supplier's cost of goods sold with respect to the export property. In the year of resale by the DISC a second amount must be paid by the DISC to the related supplier, the rest of the price which would have been paid the related supplier (under the chosen method) if the whole sequence of events had taken place in the year of initial transfer of property to the

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127. *Huber Homes, Inc. v. Commissioner*, 55 T.C. 598 (1971).

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DISC and if all costs and expenses of the DISC and related supplier attributable to the transaction had been incurred that year. The effect of this rule is quite beneficial to the related supplier, for it permits a substantial mismatch of the taxable income from the export transaction and the deductible expenses attributable to that income. This could have been prevented by a rule that would defer the deductions of the related supplier until the year of resale by the DISC, but no such rule is provided, and it must be presumed that the distortion will be countenanced.

Concern about the special rule for such incomplete transactions is not limited to the distortion implicit in the mechanics chosen for its implementation, it is also possible that the special rule will have some effect upon the interpretation of section 482 and doctrines of other sections related thereto, especially where there are transactions between brother-sister corporations. Upon analysis, it would seem that cases like *Challenger* and *Knipe*,<sup>128</sup> really depend for their constructive dividend-capital contribution result upon the notion that, at least to the extent of the difference between the amount paid and the fair market value of the property transferred, there is no "sale" of the property. Yet, for section 994 to apply to a transaction, it must fall into one of the categories covered by the statute or the regulations, and these are generally limited to sales, leases, and the provision of services. It would not be supportable to characterize the sort of situation involved in a sale between brother and sister corporations as the performance of services, or the lease of export property, so the only reasonable category must be sale. There is nothing in section 994, or in the other DISC provisions, that remotely says such transactions between brother-sister corporations are any different in fundamental character under DISC than they are under the rest of the Code, and thus it seems inescapable that an inference of the application of the section 994 rules to such transactions suggests at least a partial abandonment by the Treasury of the characterization of such transactions as constructive dividend and capital contribution.

It could, and probably would, be argued that this inference does not necessarily follow since the DISC provisions are special and in many respects constitute an exception to the generally applicable results of tax law, and that this is just another instance of such an exception. To make such an argument, however, would seem to require some specific language in the statute to which one could point to support such assertion. An alternative argument would be that the regulations, to

128. George W. Knipe, 24 T.C.M. 668 (1965), *Affd. sub nom.*, Equitable Publishing Co., 356 F.2d 514 (3rd Cir. 1966); *Challenger, Inc. v. Commissioner*, 24 T.C.M. 2096 (1964).

the extent they permit such transactions to be included within those transactions eligible for the section 994 special pricing rules are invalid, and that therefore the inference does not arise, but it seems unlikely that authorization to argue that the regulations are invalid would be forthcoming. Finally, it could be argued that the reading of the *Challenger-Knipe* line of cases set forth above is incorrect, an assertion which would require an excursion into the matter well beyond the scope of this paper. Perhaps the matter should be left, in fairness (since I have not really answered the last, and perhaps most potent of these arguments), by saying that the problem would not seem to arise if the reading of those cases is incorrect.

Perhaps because of difficulties in administering the rules of section 482 regulations 1.482-2(e)(1)(iv) relating to the permissible groupings of products into product lines for pricing purposes, 1.994-1(c)(7) almost abandons any attempt to impose reasonable groupings for such purposes under section 994. Under 1.994-1(c)(7) any grouping of products into product lines will be accepted if "it conforms to *any* recognized industry or trade usage" (emphasis added). In view of the enormous number of different circumstances under which pricing, and therefore grouping decisions are made for non-tax purposes, it would seem extremely difficult to disallow the taxpayer's asserted industry practice, and thus substantial manipulation of groupings may be anticipated. For example, if the most reasonable groupings of products into a product line would include a few high profit margin products with several low profit margin products, but a possible grouping would include only the high profit products in one, and the other products in another grouping, the related supplier and the DISC could choose to group the high profit products together under the loose grouping rule of the regulations so that the combined taxable income method would yield maximum taxable income from such sales in the DISC, and so that the 4 percent method would yield the best treatment of the low profit products (for example, if the low profit margin products yielded an average profit of less than 8 percent, ignoring EPE). The manipulation possibilities implicit in this approach would seem a rather high price to pay for ease of administration, if that is its purpose.

Section 994(b)(1) authorizes the Commissioner to issue rules applying the special pricing rules of section 994 to transactions other than sales, and this authority is exercised in 1.994-1(d). Generally, these regulations permit section 994 pricing with respect to leases, commission sales, and services.

1.994-1(d)(1) provides, in the case of leases, that the rules applicable to sales shall be applied by analogy. Thus, to the extent they make sense as applied to leases, the taxpayer must go through the relevant



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rules for sales and determine the appropriate analogy which would make sense as applied to leases. It appears the rules for leases would be applied on a year-by-year basis, since the proposed regulations refer to computation "for any taxable year." A fairly clear implication which may be drawn from this language is that a different method may be selected for each year of the lease, permitting a veritable bonanza for related suppliers which lease property for use abroad.

In the early years of a lease, when it may be presumed the related supplier will select an accelerated form of depreciation, the section 482 method could be chosen. Under this method, if the DISC has substance and performs a function with respect to the lease, the charge for lease to the DISC for re-lease abroad could be such as to permit the DISC to realize taxable income even though the related supplier realized a loss because presumably an unrelated third party in the place of the DISC would be entitled to a profit even though its lessor realized a loss. For the middle years of the lease, the parties could select the 4 percent method, which would permit maximum taxable income in the DISC as depreciation decreased and combined income consequently increased (until combined income reached 8 percent of the lease payments to the DISC plus EPE). In later years of the lease, the parties could select the combined taxable income method, which would permit maximum income in the DISC as depreciation reached very small amounts and combined income consequently rose.

In a typical net lease situation the profit, economically speaking, comes from the tax savings from depreciation, interest on borrowing to purchase the leased property, and the investment credit. A very small economic profit (if one ignores the present value at the time of the purchase of the profit to be derived far in the future) may be realized from sale of the leased property at the end of the lease, often to the lessee. While the investment credit would not be allowed for property purchased for use abroad, the benefits of DISC deferral of a portion of the income derived from the lease, as set forth in the preceding paragraph, would seem to more than make up for such credit. In the absence of a rule to the contrary it would also seem that the sale of the leased property at the end of the lease would be eligible for the special section 994 pricing rules. This would have two consequences, the only real economic profit from the transaction is permitted to be separated from the artificially treated income from the lease payments, and it is possible that the effects of depreciation recapture would be significantly lessened.

Special rules are provided under section 995 for the situation where property which would produce recaptured income if sold is contributed

to the DISC in a tax free exchange and later sold by the DISC,<sup>129</sup> but there seem to be no rules for a sale of such property on a commission basis through the DISC. Absent such a rule, it would seem the DISC would be entitled to a commission from sale of such property equal to the amount it would have received (as its share of the income under the pricing rules) if the property had been sold to it and resold by it. In short, the sale which would produce recaptured income would be the one to the foreign purchaser and by giving the DISC its share of such receipts, a portion of the gain treated as ordinary income under the recapture rules would be sheltered as DISC income. Roughly, the amount so sheltered would be 25 percent of the gain under the combined taxable income method (because the DISC would get one-half the combined taxable income from the sale (in this case, the amount of the gain) and one-half of that one-half would be deemed distributed to the shareholders of the DISC) and thus recapture would be substantially lessened.

The absence of any meaningful rules for leases makes it impossible to determine with any certainty which of the sale rules of 1.994-1 will apply. For example, would the special loss rule for the 4 percent gross receipts method apply to leases? If so, in the early-middle years of a lease, where the related supplier engaged in many lease transactions which were profitable, and thus where the average rate of profit was greater than 4 percent, an amount of income which would produce a loss to the related supplier could be allocated to the DISC because the accelerated depreciation used by the related supplier would reduce its taxable income to a low percentage of lease payments.

As with sales and other transactions subject to the section 994 rules, shifting expenses which would qualify as EPE into the DISC could be used to keep the DISC's share at the maximum permitted by the no-loss rule. Generally, shifting expenses between the DISC and related supplier would have no effect on the respective shares each would receive of the taxable income from a transaction under the combined taxable income method, and the same is generally true under the 4 percent method except where the no loss rule comes into play. The treatment of some expenses as EPE, however, changes this to a small extent, since the share of the DISC is increased by 10 percent of such expenses. The general effect of increasing the DISC's expenses by 1, if such expense qualifies as EPE, is to increase the amount of income deferred by .05. This is so because 10 percent of that 1 (.10) is added to the DISC's share of taxable income from the transaction, and one-half of that increase of .10, or .05, will generally be deemed distributed to the

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129. Section 995 (c).

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related supplier (as shareholder of the DISC). If profit margin is low, and expenses are a large fraction of receipts and most of such expenses are capable of being EPE if incurred by the DISC and are readily shifted, it would seem possible to keep the DISC's share of taxable income near the maximum under the no-loss rule fairly easily.

The rules relating to commission sales reflect the rule of section 993(f) that the gross receipts of the DISC will be considered the receipts of the related supplier. Thus, the DISC is entitled to receive as a commission the same amount that it would have been entitled to receive if the property had been sold to the DISC by the related supplier and resold by the DISC. As with sales to the DISC for resale by it, the method used in pricing may be selected for each taxable year to permit the desired share of income in the DISC.<sup>130</sup>

Services are fairly difficult, and the regulations deal adequately with them only to a limited extent. In applying the section 994 methods to services it is first necessary to determine whether the services will be treated as independent of, or as part of a sale to which they may relate. For example, if the DISC sells export property and also enters into a contract with the buyer for the performance of routine maintenance on such property, the question arises whether the receipts which are attributable to the services (assuming they qualify as Qualified Export Receipts) should be lumped with the receipts from the sale in making the section 994(a) computations, or whether the receipts for the services should be treated separately. The further question arises whether services which produce Qualified Export Receipts under either of two categories (*i.e.*, services which are both related and subsidiary to a sale of export property and also qualify as either architectural and engineering, or as managerial) should be treated differently from those which only qualify as related and subsidiary. The regulations clearly answer the first, but the answer to the second is less clear.<sup>131</sup>

Under 1.994-1(d)(3)(i), if the receipts from the related and subsidiary services are includible in the income of the DISC in the same taxable year as are the receipts from the sale to which such services relate, then the receipts from both the services and the underlying transaction are lumped in making the section 994 computations. It is not entirely clear whether this lumping rule is to apply separately to each taxable year, or whether it is to apply to all or none of the taxable years.

Whether the receipts from services which are both related and subsidiary and also architectural and engineering, or also managerial are to be lumped with the receipts from the sale or other transaction to which they

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130. Reg. § 1.994-1 (d) (2).

131. Reg. § 1.994-1 (d) (3).

relate is unclear. The regulations provide that the section 994(a) computations are to be made separately for the receipts and costs of services which are productive of QER under section 993(a)(1)(G) or (H), or for related and subsidiary services the receipts from which are not includible in the same year as the receipts from the transaction to which they are related, but the regulations do not make it clear which category related and subsidiary services which are also, for example, architectural, fall into. Perhaps the safest way to read the language of the proposed regulations is to assume that receipts from these two category services are to be treated separately.<sup>132</sup>

A limitation imposed by the legislative history, but not appearing in the statute, is that the special pricing rules may not be applied to produce a loss to the related supplier.<sup>133</sup> The regulations provide two loss limitation rules, a general one, and a special one which applies only under the 4 percent method.<sup>134</sup>

Under the general rule of 1.994-1(e)(1)(i), neither of the special pricing rules may be applied to “. . . cause . . . a loss to the related supplier . . . but either may be applied . . . to the extent it does not cause a loss.” Thus, even if either or both methods may produce a loss for the related supplier, the loss producing method may be used, but the amount of profit which may be shifted to the DISC under that method is limited to an amount which will cause the related supplier to break even. For purposes of this rule a “loss” means that the income of the DISC from the transaction is greater than the combined taxable income of the DISC and related supplier from the transaction. But, a price which permits the DISC to recover all its costs attributable to the transaction does not produce a “loss.” Thus, even though the overall transaction is a losing one, some amount less than the gross receipts (derived by the DISC) from the transaction may be charged the DISC by the related supplier to assure that the DISC does not have a loss, or, to put it the other way, to assure that the loss is borne by the person who can make the greatest current use of it for tax purposes.

These general principles do not, of course, apply where the section 482 method is chosen. Under that method, as under section 482 generally, the DISC is entitled to be charged the price an unrelated third party would have paid the related supplier. Thus, if the related supplier had sold a particular product or product line at a loss in the past, *and* if the DISC has substance, and performs a function with respect to the transaction, it should be entitled to a profit because an unrelated third

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132. *Id.*

133. Senate Report, p. 107.

134. Reg. § 1.994-1 (e) (1).

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party in the place of the DISC would presumably expect a profit even though its seller realized a loss.

In the case of the 4 percent gross receipts method, a special rule is provided (dealt with more thoroughly in the section of this paper dealing with marginal costing). Under this rule a price will not be considered to produce a loss under the 4 percent method if the price determined allocates to the DISC no more net profit, as a percentage of sales receipts, than the related supplier and the DISC together receive on all their sales of the product or product line (foreign and domestic) to third parties. This determination is made year-by-year, and applies with respect to sales within a particular taxable year of the DISC to the overall sales of the DISC and related supplier for that year. Apparently the purpose of this provision is to introduce an element of "marginal costing" into the no-loss rule.<sup>135</sup>

As noted previously, the application of section 994 can be materially affected by an adjustment to income or costs under section 482. Thus, for example, if an adjustment is made to the price which the related supplier paid for property from a related person which was then sold to the DISC for resale, the costs of the related supplier would be increased or decreased by the amount of the adjustment, and combined taxable income would be increased or decreased by the same amount. If the combined taxable income method was chosen, it is conceivable that the adjustment would result in the transaction being a loss, and would thus require adjustment. On the other end of the transaction, an adjustment might be made under section 482 of the price charged by the DISC to a related third person to which it sold the property. Such an adjustment, by increasing or decreasing the gross receipts from the transaction, would have a similar effect on the section 994 computation. On this end, however, a special rule is provided which has the effect of forcing the revenue agent proposing the adjustment to take into account not only the function performed by the DISC, but also that performed by the related supplier. Without such a rule, revenue agents hostile to DISC might be tempted to undercut its benefits by claiming that the DISC had performed no economic function in the transaction (as will often be the case) and therefore was entitled to no income.

Section 482 allocations could also be made with respect to dealings of the related supplier and DISC which were not within section 994. For example, a cost of the DISC may have been claimed on the related supplier's return, or vice versa. Since the protection of section 994 applies only to the computation of transfer price, and not to the

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135. Reg. § 1.994-1 (e) (1) (ii).

elements which are used in making such computations, an allocation of the item of expense could be made under section 482 to the proper party. If the item was treated (as reported by the related supplier) as attributable to non-DISC transactions, or if the item could qualify as an export promotion expense, a substantial effect on the pricing computations would follow, and perhaps would cause a change in choice of method.

In the former case, since the related supplier treated the item as not attributable to DISC transactions, it did not figure into the computation of combined taxable income attributable to any group of such transactions; allocated to DISC transactions (whether, that is, allocated to the DISC, or within the related supplier's return to DISC transactions), the item would reduce combined taxable income, and require a recomputation of transfer price. If the item qualified as an export promotion expense, allocation from the DISC to the related supplier would reduce the DISC's share, since the extra 10 percent of income permitted for such expenses would be reduced.

The methods of section 994, especially where several products are grouped together, generally will require whole-year figures to make necessary computations. Thus, only an estimate of the correct 994 price can be made at the time of a particular transaction. The regulations meet this situation generally by permitting adjustment to the transfer price after the close of the DISC's taxable year. The amount due the DISC must be paid to it within, generally, 60 days after the close of the DISC's taxable year, and if such amount is not paid interest bearing obligations are created.<sup>136</sup>

Under both the 4 percent gross receipts method and the combined taxable income method the DISC is entitled to profit which includes 10 percent of its "export promotion expenses." The regulations reflect the importance of such expenses by devoting considerable space to explication of the relevant rules.<sup>137</sup>

In the legislative history export promotion expenses are defined only in general terms. A bit more is provided in Treasury's DISC-selling brochure. In general, these expenses are those which are ordinary and necessary expenses incurred by the DISC with respect to a transaction giving rise to qualified export receipts. Not all items of expense are allowed as export promotion expenses (hereinafter, EPE), however, and some items of cost of goods sold are so allowed.<sup>138</sup>

136. Reg. § 1.994-1 (e) (4): proposed regulations § 1.994-1 (e) (3), (5), (6), 40 Fed. Reg. 29873, July 16, 1975.

137. Reg. § 1.994-1 (f).

138. Senate Report, p. 108; DISC: A Handbook for Exporters, G.P.O. (1972), at 27-28.

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Four general criteria must be met for an expense to qualify as EPE. It must be "incurred" by the DISC. It must advance the distribution or sale of export property for use, consumption or distribution outside the United States (or perform a similar function with respect to leases, services, etc.). It must, generally, be an ordinary and necessary business expense of the DISC. It must be attributable to the qualified export receipts from a particular transaction or transactions to which the rules of section 994 apply.<sup>139</sup>

From the language of 1.994-1(f)(1), it would appear that expenses will not be EPE unless they relate to export property. Thus, costs related to management services, or architectural and engineering services, will not be EPE unless such services would also qualify as related and subsidiary, or the taxpayer can convince the Service that they relate to an export of property.

In general, it should be noted that the rules of 1.994-1(f) deal only with the allowance of an expense as EPE. Even though an expense fails to qualify as an EPE, it may be allowed as a deduction to the DISC in computing taxable income, and the transfer price under the section 994 rules.

Whether or not required to be treated as costs of goods sold under the appropriate methods of accounting; depreciation on the property of the DISC, freight (as limited) and the cost of packaging are allowed as EPE. Other cost of goods sold items presumably would not qualify.<sup>140</sup>

Income or similar taxes are not allowed as EPE. The effect of this limitation is, however, somewhat mitigated by the provisions of sections 502 and 503 of the Act, which treat certain distributions of the DISC as though they were from a foreign corporation and allow a passed-through foreign tax credit to that extent. Interest, bad debts, freight insurance, and costs of manufacture and assembly are also ineligible.<sup>141</sup>

One-half the expense of shipping export property is allowed as EPE if it is for shipping on U.S. flag carriers. For this purpose insurance charges are not included, but several other miscellaneous expenses are included (the most important of which are probably the ground transportation charges at the dock or airport). No freight expense is allowed as EPE if law or regulations require that the particular property be shipped aboard a U.S. flag carrier. Presumably this requirement is designed to encourage the use of U.S. carriers by placing a premium on the deduction for such expense. Detailed rules are also provided for

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139. Reg. § 1.994-1 (f) (1).

140. Reg. § 1.994-1 (f) (2).

141. Reg. § 1.994-1 (f) (3).

such matters as proration of the cost of shipping partly within and partly without the United States.<sup>142</sup>

The cost of packaging export property is permitted as an EPE even though the package is the same as that used for items of the property sold domestically. A difficult issue is the treatment of containers used for shipping. In a sense these are packages and in a sense the cost is freight. The regulations deal with the problem by providing that containers leased from the shipping company that transports the export property are not packages, and intimates that such lease charges may be freight. This, of course, leaves open the case where the containers are leased from one company and the goods are transported by another. In such a case it appears that the cost of the container would be neither freight, since it is not for the transportation of the property and is not an integral part of the charge for the transportation of the property (as it might be if the charge for the container was part of the charge for the transportation of the property by the same company that was moving the goods), and it is not a cost of packaging, since the kinds of packages to which the regulations seem to be referring are those which are more integral with the property, and not those which are intended for use merely at one stage of the transportation of the property.<sup>143</sup>

With respect to labels and the cost of designing special packages, the cost will be an EPE only if it relates to export sales. Thus, only if a separate design is developed for export sales will the cost of development of such design be allowed as an EPE, and if the same design is used for domestic sales, the cost will not be EPE.<sup>144</sup>

In order to qualify as an EPE a cost must be incurred by the DISC. This is perhaps the only significant substance requirement in all of the DISC provisions. The rules for determining when an expense is incurred by the DISC generally make a fundamental distinction between expenses in which a related person of the DISC is involved, and those in which the DISC acts alone. There are few problems where no related person is involved, and such expenses would usually be treated under the general rules for EPE.<sup>145</sup>

Where a related person is involved and the action for which the expense is incurred is to be performed by a third party, the DISC must generally be a party to the contract under which the action is undertaken and the charge may not simply be assigned to the DISC after it is incurred. For example, if it is desired to engage a consulting firm to perform a market survey in a foreign country, in order for the charge

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142. Reg. § 1.994-1 (f) (4).

143. *Id.*

144. Reg. § 1.994-1 (f) (6).

145. Reg. § 1.994-1 (f) (7).



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for such service to be an EPE, the DISC would have to be a party to the contract under which the survey is performed, and a reimbursement of the charge to the related supplier after it had been paid to the consulting firm would not qualify as an EPE.<sup>146</sup>

Where the cost is for the use of a related person's property, only the cost of space in the related person's building for DISC employees or property is allowed as EPE. The wording of the regulations is ambiguous, however, as to expenses for services performed for the DISC by a related person where the DISC pays the normal arm's length charge for the services. Reimbursements of expenses incurred in the first instance by a related person are not allowed as EPE (as noted above) unless they are for contracts with independent contractors and the DISC is a party to the contract. In the absence of definitions of "independent" it is difficult to tell whether the payment of an arm's length charge for services performed by a related person would be treated as payment for independent contractors or reimbursement.<sup>147</sup>

A minor but troublesome aspect of the "incurred" requirement is promotional literature. For example, if a major automobile manufacturer requires overseas dealers or distributors to pay for promotional brochures, are the costs of the literature an EPE, or are they a cost of export property (that is, is the literature export property)? The problem is largely conceptual: the item is both a cost of selling cars, and a cost of producing something (the brochure) which produces receipts. In this light it is rather like the problem of related and subsidiary services. The regulations impose a mechanical rule: if the cost of the promotional literature is greater than the receipt from its sale, the excess of the cost over the receipt is an EPE. Presumably in such case the receipt from sale of the material would be QER (if the property promoted produces QER?) and the cost of the material would be lumped, as would the receipt, with the costs and receipts from sale of the export property promoted. On the other hand, where the amount received from the promotional literature is greater than its cost, no part of the cost is EPE, and the regulations merely cross reference to all the regulations under section 993. Apparently the theory of the regulations is that if a seller is merely trying to cut his costs, that is, is apparently not trying to make money, then he is saying he doesn't regard the costs as relating to an independent transaction, but that they are really part of the larger transaction (the sale of cars, in the example above). But if the seller is pricing the material so that he is making money, then he is treating the sale of the material independently from the sale of the property to which

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146. Reg. § 1.994-1 (f) (7) (ii) and (iii).

147. Reg. § 1.994-1 (f) (7) (iii).

the material relates (or to put it another way, he is saying that it is not his cost, that it is the cost of the foreign buyer-reseller).<sup>148</sup>

Generally under the 4 percent gross receipts and combined taxable income methods, shifting costs which figure in the computation of combined taxable income between the DISC and related supplier will neither increase or decrease the share of either. This is so because the share of the DISC under each method is net of expenses, that is, the method permits the DISC a specified share of the price with reference to the taxable income this will give the DISC. Generally, then, increasing the expenses of the DISC by \$1 will decrease the price it must pay the related supplier by the same amount, and thus will neither increase nor decrease the net income of the DISC from the transaction. Qualification of an expense as EPE, however, somewhat changes the equation.

The pricing methods permit the DISC taxable income equal to one-half the combined taxable income, or 4 percent of the gross receipts, from a transaction plus 10 percent of the export promotion expenses. Thus, shifting a cost to the DISC which is an EPE increases the share of the DISC by 10 cents for each dollar of cost so shifted. Since generally one-half the DISC's income will be deemed distributed each year to the related supplier-shareholder, the net effect of shifting a cost to the DISC which is an EPE is to reduce the taxable income of the related supplier 5 cents for each dollar shifted.

### MARGINAL COSTING

Section 994(b) authorizes the Treasury to issue rules for the allocation of costs in determining combined taxable income under the combined taxable income method of section 994(a)(2), the so-called marginal costing provision. The Senate Finance Committee Report elaborates on this authority by indicating that these rules would permit pricing on the basis of costs which are less inclusive than those required by the usual Code rules for inventory costing, generally the newly amended regulations 1.471-11. Regulations 1.994-2 implement this authority, by providing that the related supplier and the DISC may take into account only the direct variable costs related to the product, and export promotion expenses if the DISC treats expenses as such. While this allowance applies only in the case of the combined taxable income method, the no-loss rule applicable to the 4-percent gross receipts method under regulations 1.994-1(e)(1)(ii) is somewhat similar and will be considered herein.<sup>149</sup>

148. Reg. § 1.994-1 (f) (7) (v).

149. For an excellent general treatment of marginal costing see, Kauder, *Marginal Costing for DISCs: An Explanation and Analysis of Treasury's Proposed Regs.* 39

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Generally under section 471 the trend appears to have been toward requiring more items formerly treated as period costs to be included as inventory costs so that current income will not be understated for tax purposes. In its first recent notice of proposed rule making announcing new proposed regulations 1.471-11, Treasury sought to require nearly "full absorption" costing, that is, coming reasonably near to requiring that all costs fairly attributable or allocable to particular items of property be treated as inventory costs of these items, and thus not reduce gross income until the revenue from these items is realized.<sup>150</sup> To some extent this requirement was weakened by the second notice of proposed rule making, perhaps in the hope that the accounting profession would adopt such a requirement on its own.<sup>151</sup> In any case, as adopted, the new regulations 1.471-11 require some fixed costs to be included in inventory. The marginal costing rules under regulations 1.994-2 go in the opposite direction altogether, and in 1.994-2(b)(2) require only that direct material and labor costs be taken into account.

Since it can be assumed in every reasonably likely case that the related supplier and the DISC will incur some fixed costs, and not merely direct costs of materials and labor, in every case the income of the DISC and related supplier from sales of export property will be increased, thus potentially increasing the amount of income eligible for deferral under the DISC provisions. As a corollary, the costs which would have been treated under the usual rules (1.471.11) as attributable to the property sold to the DISC, are allocated to other property sold by the related supplier, thus reducing at least some income which would have been fully taxable.

Section 994(b)(2) provides that the marginal costing rules shall be issued to apply to cases where the DISC is attempting to "establish or maintain a market for export property." The rules of the regulations provide that this condition is met whenever the combined taxable income of the DISC and related supplier from sales of the export property is greater using marginal costing than it would be if full costing were used. In effect, the marginal costing rules, then, may be used in every case of export sales, since it is unreasonable to assume that there will be a situation where there are no fixed costs. On its face this would seem an abdication of a standard altogether, but as Kauder points out, the standards of the section 482 regulations which authorize marginal costing in some cases would almost automatically be met in those cases

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JOURNAL OF TAXATION 304 (May, 1973). I have tried to duplicate the information in that article as little as possible.

150. 36 Fed. Reg. 23809 (1971).

151. 38 Fed. Reg. 4337 (1973).

where marginal costing would be of advantage to the DISC. This is so because the use of marginal costing is permitted only to the extent its use does not exceed an "overall profit percentage", which, as more fully discussed *infra*, effectively limits marginal costing to situations where either the costs of export sales are greater than the costs of domestic sales, or the selling price realized on such sales is less than that for domestic sales.<sup>152</sup>

It is not entirely clear just how the direct material and labor costs are to be determined. It is possible to read the language of 1.994-2(b)(2), which merely refers to section 471 and regulations 1.471-11, as referring to incremental costs of material and labor, that is, as referring to the amount by which costs of material and labor of the related supplier are increased because of the production of the particular units of the product sold to the DISC (presumably treating such units as the last produced in the taxable year). It is more reasonable, however, to assume that the reference to section 471 and regulations 1.471-11 requires the determination of such costs on an average per unit annual basis, and that the determination of the manufacturing costs attributable to particular items sold to the DISC would take into account a ratable share of the direct costs of producing all currently produced units of the product, including those sold to the DISC and those not sold to the DISC.<sup>153</sup>

Pricing, under both the regular section 994 methods dealt with in regulations 1.994-1 and under the marginal costing rules of 1.994-2, requires rules for grouping transactions or products to which the pricing rules are applied. Under the section 994(a)(1) and (2) methods, pricing is permitted with respect to groups of transactions if they relate to the same product or product line, and separate computations for each item of export property are not required. Because of the limitation of the "overall profit percentage", it is possible that a taxpayer may benefit from a realignment of products into different product lines, for example, so that particular items of property which have a lower foreign than domestic selling price will be in one group, to which marginal costing would be applied, and others that have a higher foreign than domestic selling price will be in another grouping, to which the full costing rules would be applied. Presumably to prevent such manipulations, 1.994-2(c)(3)(i) requires the same grouping to be used for marginal costing purposes as is used for non-marginal costing sales to the DISC. Since the rules referred to, however, are rather loose (permitting annual choice of groupings, and methods which conform to "any recognized

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152. Proposed 1.994-2 (c).

153. Kauder, *supra*, note 146, at 308.

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industry or trade usage" (1.994-1(c)(7)) it is hard to see how the taxpayer will be prevented from manipulating his groupings to achieve maximum tax benefit. Thus, for example, if in taxable year one the prevailing price for domestic sales is higher for one of three types of units which were previously treated as a group and lower for the other two than the prevailing foreign price for that year, the taxpayer could probably easily establish some trade usage that would justify grouping the two types of units with high foreign prices into one product line, and determining the pricing for them under the usual full costing rules, and treating the type of unit with a low foreign selling price as another grouping. Since the choice is annual, in the following year, taxable year two, the taxpayer might find that the foreign price for the formerly low-foreign-price unit was higher, and might therefore establish another trade usage to justify grouping the product with its companions (though the taxpayer might not find this necessary, since he could merely decline to elect marginal costing for the second year, unless there was some advantage to be obtained, for example, selection of a separate pricing method, by keeping the units separated into two groups).

The costs of the related supplier which (1) would have been required to be included in inventory costs of the products sold to the DISC and (2) but which are not because of the election to use marginal costing for those sales are allocated to "the production of the related party which is not sold to the DISC." There is no guidance concerning such allocation in the regulations. Perhaps the most obvious question is whether the language quoted above means exactly what it says ("which is not sold to the DISC"). If so, a remarkable bonanza would be available to related suppliers. For example, if a related supplier produced two products, A and B, and sold A in part through the DISC and in part to independent wholesalers in the United States, and if product A was profitable domestically but less so in export sales, but product B was not very profitable, sales of A on a marginal costing basis to the DISC could produce sufficient non-marginal costs which would have to be totally allocated to product B (because it was not "production . . . sold to the DISC") to cause the sales of product B to be at a loss. It is hard to believe that the congressional policy underlying DISC requires sheltering not only export income but also domestic income of other products, so it may be that Treasury will read the above language to mean the non-marginal costs involved would be allocated to all other property sold by the related supplier, whether or not to the DISC (but presumably excluding any reallocation of the non-marginal costs back to the property sold to the DISC if not disposed of by the DISC in the year of sale by the related supplier to the DISC, and where non-marginal costing is elected for the year of resale by the DISC of that property; one could raise questions

about this, however, for the regulations do not provide any transitional rules for cases such as that posed here. See 1.994-1(c)(5).<sup>154</sup>

Even if costs are allocated to property sold to the DISC as well as property sold to others, the effect of the marginal costing rules would be of considerable benefit to the related supplier, since such costs would reduce income from sales of such other property, thus shifting income from at least some fully taxable sales income of the related supplier to DISC sales, and thus deferring one-half the tax on such sales income.

A possible deterrent to the gaudier abuses possible might be a broad reading of the "no loss" rule. Generally, the pricing rules of section 994, including the marginal costing rules, are not permitted to be used to the extent that they result in a loss to the related supplier from the transaction.<sup>155</sup> Where, as noted above, a loss on sales of other property might be created by a shifting of costs from the marginally costed property, it could be argued that the congressional policy that no losses result requires a limitation of such shifting to an amount which would cause the related supplier to break even. Clearly this is not the situation contemplated by the language of the no loss rule as expressed in the legislative history and the regulations (generally, a loss is defined in terms of the amount of taxable income realized by the DISC being in excess of the combined taxable income of the DISC and related supplier from the transaction) but it could be argued that the policy requires this result anyway. It is somewhat doubtful, however, that Treasury is willing to take a hard line on this matter, since they treat the "no loss" rule in regulations 1.994-1(e)(1)(ii) as a way of introducing marginal costing through the back door under the 4 percent gross receipts method (section 994(b)(2) authorizing marginal costing *per se* only in the case of the 50-50 combined taxable income method). It is hard to see behind such provision a mind in search of abuses to prevent.

There are a few minor limitations on the use of marginal costing. Thus, it may not be used if the seller (the DISC) sells to a related person within the meaning of section 954(d)(3), and ultimate sale by such related person gives rise to foreign base company income described in section 954(d) (unless sections 954(b)(3)(A) or (b)(4) apply). Marginal costing may also not be used with respect to leases or services. In the case of services, this presents an interesting technical quirk, since 1.994-2(a) specifically mentions related and subsidiary as well as other services within the prohibition. The rules of 1.994-1(d)(3) relating to services, in part, were designed to prevent taxpayers from splitting services from the sale to which they were related and subsidiary at their

154. The language quoted appears in the Senate Report, at page 108. The regulations provide no guidance whatsoever on this question.

155. See Reg. § 1.994-1 (e) (1).

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option, to enable the most favorable pricing treatment by using different pricing methods for the services and for the sale. In effect, the prohibition of 1.994-2 (a) permits the taxpayer an election. If the property is really a way of making profit from the related services which a purchaser will require, the taxpayer can avoid the required grouping of the receipts from the services and the receipts from the sale by electing marginal costing with respect to the sale of property. If the sale of property is not profitable on a full cost basis, marginal costing may very well produce a profit; some of which can be shifted to the DISC. The profit with respect to the services can be increased to the point where considerable advantage is obtained by application of the usual section 994(a)(1) or (2) methods. Probably because of the technical difficulties involved, marginal costing is also not permitted with respect to leases of property.

Under both section 994(a)(1) and (2), the DISC is permitted to pay that price which will give it not only one-half the combined taxable income or 4 percent of the gross receipts, but is also permitted to recover 10 percent of its export promotion expenses. Supposedly the policy underlying this double deduction (EPE are also taken into account in determining the combined taxable income and the taxable income of the DISC) is to encourage performance of real functions of DISCs. It is hard to see how this would increase jobs or exports (since the function, if important, would presumably be performed, whether by the DISC or related supplier, anyway), but in any case the allowance is effectively eliminated if marginal costing is elected. Under 1.994-2(b)(2)(ii), the parties are put to the choice: they may take EPE items only as deductions in determining combined taxable income and taxable income of the DISC and they are not required to treat EPE items as costs under marginal costing, or the parties may take EPE both as deductions and as an increase (in the amount of 10 percent of the EPE) in the DISC's share of combined taxable income but then must also treat such items as costs under marginal costing. The choice is illusory, as Kauder points out, because taking EPE as an increase in the share of the DISC will end up reducing the DISC's share of combined taxable income. For example, if the marginal costs of a product are 50 without including EPE therein, and the receipts from sale of the property are 100, and if EPE are 10, taking EPE as an increase of the DISC's share would increase the DISC's share of combined taxable income by 1 (10 percent of 10) but would decrease the combined taxable income by 10 (because costs would be increased by 10), and thus would decrease the DISC's share by 4 (one-half of 10 less one, *i.e.*, the amount of the decrease is decreased by the amount of the increase for EPE).

Clearly the most important rule in the marginal costing regulations is

the overall profit percentage limitation. This percentage is defined in 1.994-2(c)(2) as the percentage which the taxable income of the related supplier and the DISC from all sales of the product or product line, whether or not to the DISC, is of the total receipts of the DISC and related supplier from such sales. Thus, if the related supplier sells some items of the product or product line to the DISC for resale and some to independent wholesalers (whether such sales by the related supplier are domestic or foreign), the gross receipts from all such sales must be totaled to make up the denominator of the fraction. The numerator is the taxable income of the DISC and related supplier from such sales (in the case of sales to the DISC by the related supplier, combined taxable income is used, and the receipts of the related supplier from the sale to the DISC are eliminated). An obvious problem of this determination is the absence of rules in the Code for a domestic context similar to those of section 861(b) for the determination of expenses attributable to particular receipts. Presumably the principles of proposed regulations 1.861-8 would be used in making this determination, but it can be expected that problems will arise, as there does not appear much reason presently under the Code for a related supplier to make the determinations called for here. The above the line costs attributable to such receipts are determined on the full costing basis of regulations 1.471-11 and the general rules of section 471, so presumably the related supplier will have little difficulty in determining the costs for purposes of the numerator. In 1.994-2(c)(3) a curious rule is provided which permits the use of a different grouping of products into product lines for purposes of the overall profit percentage than that used for the pricing of sales to the DISC, so long as the method is "at least as broad" as the method chosen under 1.994-1(c)(7). No clarification of "broad" is provided, however, and it could mean various things. For example, the taxpayer could argue that a new grouping which included fewer particular items, but of which more units were sold was more "broad" than the regular grouping. Perhaps what was meant was a grouping that includes as many, at least, particular items would meet the "broad" test.

The regulations also permit, under 1.994-2(c)(2)(ii), the related supplier to elect to take into account, in determining the fraction, all sales by domestic members of the controlled group which includes the DISC. In effect this permits some interesting shifting of income and taxes, since the members of the controlled group which includes the DISC include those which are 50 percent controlled (and which thus are not required to be included in the consolidated return, if any, of the related supplier), and permits some searching to find the required situation, higher percentage of profit on non-DISC sales than on DISC sales, which will make marginal costing advantageous. For example, if



the related supplier has two "subsidiaries" other than the DISC, one 100 percent owned by the related supplier and the other 79 percent so owned, and if both "subsidiaries" sell products which could be included in the same product line as the product sold by the related supplier to the DISC, the related supplier can, under the loose grouping rules, put together a new product line for products sold to the DISC which would include high-profit items sold by the 79 percent "subsidiary" but would exclude low-profit items sold by the 100 percent "subsidiary". In effect this would create the differential of profit rate between the sales to the DISC and those to others which would permit considerable increase in combined taxable income under marginal costing (because the limit of the overall profit percentage would be increased; the average rate of profit on all sales would be increased within the product line by excluding low-profit sales by the 100 percent "subsidiary") and the increase in DISC sheltered income would thus be in direct proportion to the rate of profit earned on sales by the 79 percent "subsidiary", thus shifting sheltered income into the DISC while keeping it out of the consolidated return. Perhaps the problem here is neither the loose grouping rules nor the liberality of permitting an election to include other members of the controlled group, neither of which would be all that useful alone, but the combination of the two, which permit shuffling items around until the desired computation results.

Once the elements of the fraction have been determined, the percentage which it represents is applied to the gross receipts of the DISC from sales of the product of the product line. The amount resulting is the maximum combined taxable income the DISC and related supplier can receive under marginal costing. Thus, for example, if the marginal costs of a product are 25, and the gross receipts from sales of that product are 75, the marginal costs would permit a price to the DISC of 50, so that the DISC would receive taxable income from the transaction of 25 (one-half the combined taxable income of 50). But if the overall profit percentage was 20 percent, the maximum taxable income which would be allowed would be  $7\frac{1}{2}$  to the DISC because combined taxable income would not be allowed to exceed 15 (20 percent of 75).

As Kauder points out,<sup>156</sup> the marginal costing method is of use only where the profit percentage on sales of a particular product or product line to the DISC is greater than on other such sales. This is so because the percentage of profit on DISC sales is averaged by the overall profit percentage limitation with the rate of profit on such other sales. Only where the non-DISC sales are at a higher rate of profit will the averaging result in a percentage which is higher than that earned on DISC

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156. Kauder, *supra* note 146, at 307-8.

sales, so only in those cases would there be any advantage in reducing costs for determining prices for those DISC sales.

In fact, perhaps because he ignores EPE completely (since they will never be used if marginal costing is used), Kauder does not point out that the effect of the EPE rule (*supra*) would cause the taxpayers to choose non-marginal costing even where the percentages of DISC-sale-profits and non-DISC-sale-profits are close. This would follow because the split of combined taxable income under non-marginal costing is not exactly 50-50, rather it is 50 plus EPE to the DISC and 50 minus EPE to the related supplier. Thus, as the percentage of combined taxable income which the EPE represent increases, the advantage of regular costing over marginal costing extends to cases farther and farther from the point where the percentage of profit on DISC sales is equal to the profit of non-DISC sales. For example, if the overall profit percentage limitation was 10 percent, QER from DISC sales 100, profit (under full costing) on DISC sales 8 percent (i.e., combined taxable income is 8), and marginal costs 80, the marginal costing rules would permit the DISC to increase its taxable income from 4 percent (one-half of 8 percent, and thus 4, 4 percent of 100) to 5 percent (one-half of 10 percent, the overall profit percentage limitation, and thus 5, 5 percent of 100). If, however, the effect of EPE under the non-marginal costing rules is taken into account, EPE of 20 would cause the parties to choose non-marginal costing, because the share of the DISC would be  $4 + 2$  (one-half the combined taxable income, 8, plus 10 percent of the EPE, 20). If EPE were 40, the parties would be better off with non-marginal costing under any overall profit percentage less than 16 percent (because one half of  $16\% \times 100 = 8$ , and any percentage less than 16 percent would yield a figure lower than 8 when divided by 2 to get the DISC's share). This would follow because the DISC's share of full costing combined taxable income would be increased over one-half of such amount by the amount of EPE it incurred, as long as the decrease in costs permitted under marginal costing (or to look at it the other way, the increase in combined taxable income under marginal costing) is not twice or more the amount of the EPE (this could easily be expressed as an equation centering on the relationships of the percentages of CTI which the increase of CTI under marginal costing bore to the increase of EPE). The limit of 16 percent occurs above because under the no-loss rule, under full costing, the DISC would not be allowed to receive taxable income greater than the combined taxable income (8), so EPE greater than one-half the combined taxable income would not make for an increase in the DISC's share.

It is possible that the effect of using EPE where the DISC profit percentage and the non-DISC profit percentage were close would be

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offset in part by the effect of shifting the costs of the related supplier from DISC marginal costing sales to fully taxable non-DISC sales. For example, a dollar of income in the combined taxable income of the DISC and related supplier, achieved by a reduction of costs under the marginal costing method, would be worth more than 12 cents in tax reduction to the related supplier (*i.e.*, 12 cents because \$1 of income would go one-half to the related supplier and one-half to the DISC under the 50-50 split, resulting in 24 cents of tax to the related supplier; of the DISC's one-half or 50 cents, one-half (about) would be deemed distributed to the related supplier-shareholder, so 48 percent of 25 cents = 12 cents, making total tax to the related supplier of 36 cents (12 cents deemed distributed + 24 cents tax on the related suppliers share of CTD); as compared to 48 cents tax on \$1 of income earned by the related supplier not subject to the DISC rules) because the dollar of additional income under the DISC rules could have been achieved by reducing costs of such sales and increasing costs of other sales. Depending on the rate of tax to which such other sales were subject, tax might be reduced by such cost shifting by an amount up to 48 cents, so there would be a benefit under the marginal costing rules in the amount of the difference between 36 cents and the amount by which the tax was reduced because of the increase in cost of other sales. It cannot be said with any confidence just what sort of effects would result, and thus to what extent the advantage of electing full costing and using EPE would be offset, without assuming a large number of facts, and having a clear rule on the products to which non-marginal costs attributable to DISC sales are shifted (for example, if such costs were shifted to other DISC sales as well as to non-DISC sales, the offset would be reduced because such other DISC sales would be subject to a lower rate of tax than non-DISC sales).

Kauder elaborates the general point that the advantage of marginal costing generally becomes greater as the profit on DISC sales as a percentage of revenue from such sales shrinks in relation to profit as a percentage on non-DISC sales in terms of increases in costs of the DISC sales, or decreases in revenue from such sales. This seems to simply be an illustration of situations where the percentages will differ, as they obviously would where costs are higher or revenues are lower than for non-DISC sales (the percentages being determined on the basis of costs and revenues).

According to 1.994-2(d), the no loss rule applies to marginal costing as well as to full costing in applying the special section 994 pricing methods. But any price, even one which results in a loss to the related supplier, is permitted which allows the DISC to recover its costs. This is one of the sillier provisions in the DISC regulations, since only with EPE

could the combined taxable income method produce a loss to the related supplier, and since EPE reduce combined taxable income dollar-for-dollar, the point where there is no combined taxable income to split between the DISC and related supplier will be reached long before adding 10 percent of EPE to the DISC's share would produce a loss (in effect, one dollar of EPE reduces the share of the related supplier by 10 cents, but since that same dollar would have to be included in costs under the marginal costing rules it would reduce the combined taxable income by one dollar at the same time, and this would reduce the share of the related supplier (as well as the share of the DISC) by 50 cents; since 50 cents is greater than 10 cents, it is hard to see how 10 cents subtracted from CTI would result in zero before 50 cents did). Without EPE the combined taxable income method can never produce a loss to the related supplier except insofar as the DISC is permitted to recover its costs.

As Kauder notes, the marginal costing regulation would exclude some cases where marginal costing would seem to be appropriate. Thus, for example, situations where all sales of the product were export sales through the DISC would be excluded because the overall profit percentage limitation would simply be the amount of combined taxable income with reference to which the DISC's profit would be determined under non-marginal costing rules. In most such cases, it would seem the benefit of using EPE would make non-marginal costing more attractive to the taxpayer than marginal costing. Kauder's objection to Treasury's failure to permit incremental costing seems to represent a simple disagreement over the meaning of the term "marginal."

As noted previously, the marginal costing rules apply, under section 994(b)(2), only to the determination of prices under the combined taxable income method. In defining "loss" for purposes of the no loss rule, however, Treasury's regulations 1.994-1(e)(1)(ii) permit a limited use of the same sort of marginal costing as is permitted, in effect, under the combined taxable income method and 1.994-2. In effect, the special rule for the 4 percent method defines loss to exclude that price which will give the DISC no greater profit, as a percentage of the QER realized on its sale of the export property, than the average profit as a percentage of sales of the property that is earned on all sales by the related supplier and the DISC together. For example, if the sales through the DISC and the sales by the related supplier together produced receipts of 100, and the total costs of the DISC and related supplier attributable to such receipts were 96, a price to the DISC which gave it 4 percent of the gross receipts from its sale would be permitted, even though the costs attributable to such DISC sales were greater than 96 percent of the selling price, because the price would

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not give the DISC a greater percentage of its gross receipts as taxable income than the average rate of profit on all sales, 4 percent. Since as a practical matter the overall profit percentage limitation will probably restrict the use of marginal costing to some price less than that which would otherwise be allowed (if only marginal costs were taken into account), it would appear that the special no loss rule would operate similarly to the marginal costing rules.

The similarity of the special no loss rule and the marginal costing rules is underscored if a broad view of the marginal costing rules is taken. In effect, with the overall profit percentage limitation of marginal costing to the average rate of profit (or an amount determined with reference to such amount), Treasury is saying in its marginal costing rules that export sales should be permitted to earn the same rate of return, as a percentage of sales, as non-export sales. Mechanically, this result is achieved by reducing the costs attributable to those export sales roughly in proportion to the difference between the average rate of profit and the rate of profit on exports, but this is only roughly true because the sales through the DISC are taken into account in determining the average, so if domestic sales earn a greater percentage of profit than export sales, the overall average will be less than the average of domestic sales alone. And, dovetailing nicely with the export expansion purpose of marginal costing, the greater the proportion of total sales which are exports through the DISC, the less the overall average will differ from the average for DISC sales, and thus the less the costs attributable to those sales will be reduced under marginal costing.

Viewing the general marginal costing rules in this way, the special no loss rule is quite comparable to general marginal costing, since it seems to say that 4 percent of gross receipts will be a floor, as well as a ceiling, where export profits are lower than domestic profits; because export costs are higher than those for domestic sales. Where domestic profits as well as export profits are low (lower than 4 percent), export sales should earn roughly the same rate of profits as domestic sales. And here, too, averaging seems to phase out the benefits of the special no loss rule as export sales increase, for, if export profits are at a much lower rate than non-export profits, the greater the proportion of total sales exports constitute, the lower the overall average will be, and the less will be the DISC's share of gross receipts. Unlike the marginal costing rules, however, the effect of including DISC sales which would appear to be the best candidates for some sort of marginal costing rule, *i.e.*, those which produce substantial losses in the first years of establishing a market, is to reduce the benefits of the special no loss rule, for the average overall will be reduced by inclusion of such losses. Perhaps the problem Treasury faced was that they had authority only to define loss,

and an attempt to go to a full blown marginal costing method for the 4 percent method would have been a too obvious contradiction of the limitation of marginal costing in the statute, section 994(b)(2), to the combined taxable income method.

As a supplement to the marginal costing rules, the special loss rule would seem to be quite useful. For example, if most sales of a product were domestic and at a moderate rate of profit, and few sales were through the DISC and were at a loss (on a full costing basis), but the overall profit percentage was small, say 5 percent, the special loss rule would permit a greater taxable income for the DISC from the transaction than marginal costing, because the determination of the DISC's share is with reference to a percentage of the receipts, and is not limited to one-half the combined taxable income. And under the special loss rule, unlike marginal costing, the share of the DISC can be juggled quite directly, by putting expenses in the DISC so they will qualify as EPE.

Like marginal costing, the special rule permits juggling groupings of products to produce the desired computation. Under 1.994-1(e)(1)(iii), the determination of the average profit of the DISC and related supplier, from all sales of the product, may be made on the basis of a grouping (of products and product lines) on a different basis than that used for sales without regard to such determination. For example, the average rate of profit would be permitted to be determined under a grouping which put high-profit products together, even though the actual grouping used to determine whether there was a loss, and to what extent a loss would be permitted in application is different; to put it another way, the fraction that determines the *rate* of average profit can be based on one group, and the determination of the rate of profit that results from a particular price may be determined on the basis of another. Thus, if several products were sold to the DISC, all producing a profit but one, and the overall rate of profit was 5 percent (that is, \$5 per hundred was the taxable income from such sales, on average), the taxpayers could determine the average rate of profit on the basis of that grouping, arriving at 5 percent. They could then, under 1.994-1(e)(1)(iii) elect a different method for applying that rate to the sale of the loss product: a single product grouping (which would appear to be permitted almost *per se* under the language of 1.994-1(c)(7)) would permit the DISC to realize taxable income from the transaction equal to 4 percent of the QER from the transaction plus 10 percent of its EPE, so long as this was not more than 5 percent of the QER. Since the rules of 1-944-1(c)(7) are extremely liberal in always permitting the use of a transaction-by-transaction basis for determining prices, it would even be possible to use a single product grouping of the actual product being sold at a loss, if only some, but not most sales for

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the year were at a loss. For example, if the overall profit for the year on sales of that product were 5 percent, but a few sales for some reason (perhaps a temporary weakening of the market, or extra costs) were at a loss, the single product annual grouping could be chosen to establish the maximum 5 percent rate, and the transaction-by-transaction approach could be used to price the sales which were at a loss.

Like the marginal costing rules, the special loss rule permits costs to be shifted from products sold to the DISC, and thus from sheltered income, to fully taxable income of the related supplier. Unlike the marginal costing rules, however, there is no guidance at all as to the treatment of the costs so shifted. Presumably the related supplier would simply have a loss on sales to the DISC under such circumstances, and its taxable income from other sources would simply be less when the numbers were written down on its tax return.