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Current Developments on Domestic International Sales Corporations

Thomas R. Bretz*

Since its enactment in 1971, the Domestic International Sales Corporation (DISC)¹ has been controversial. Its existence has been threatened from the very beginning on both the domestic front and the international front. Although DISC has been in existence for over twelve years, the threats have caused some taxpayers and their representatives either to delay the establishment of a DISC or to ignore the legislation altogether.

The assailants on the domestic front, led primarily by organized labor and tax reformers, have argued that DISCs do not increase the export of U.S. products, but result in the export of what otherwise would be U.S. jobs. The argument is that those already exporting were given a break on those exports, and DISC has not caused either an increase in exports or the start of export businesses by those not formerly exporting. In other words, DISC benefits applied to all exports of a company, regardless of whether a company's products would be sold in similar amounts with the DISC export incentive, and regardless of whether the company increased or decreased its exports. The domestic assaults did not succeed in repealing the DISC legislation, but they did result in certain legislative amendments. The most significant amendment was the addition in 1976 of the "incremental rule,"² whereby tax breaks were given only for exports exceeding a base period amount measured by the average of the taxpayer's prior year's experience. These incremental rules resemble principles embodied in the five-year income averaging rules for individuals.

At the same time the domestic assaults were occurring, a major assault that threatened retaliation³ for alleged violation of the General

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¹ Domestic International Sales Corporation is codified as I.R.C. §§ 991-997 (1982).

² I.R.C. § 995(b)(1)(E) (1982).

³ The "threatened retaliation" under consideration by the European Community consists of compensatory damages of \$2.3 billion against the United States for losses allegedly suffered, and of a suspension of tariff concessions and other GATT obligations to the United States. *See*

Agreement on Tariffs and Trade ("GATT") was led by the European Community.⁴ The alleged GATT violations have proven to be the more successful threat. The Reagan Administration has bowed to GATT pressure and proposed legislation to replace DISCs. Assuming Congress cooperates, DISCs may be eliminated in the near future.

In August 1983, the House Ways and Means Committee Chairman, Dan Rostenkowski, joined by Representative Barber Conable, the ranking minority member on that Committee, introduced the Foreign Sales Corporation Act of 1983,⁵ as the Reagan Administration's DISC replacement proposal. Identical legislation⁶ was introduced on the same day by Senate Finance Committee Chairman Robert Dole. The primary purpose of the legislation is to end the GATT controversy that threatened the DISC legislation from its inception. Surprisingly, it is uncertain whether the proposed legislation will in fact end the GATT controversy. With this significant caveat in mind, this article reviews the principal attributes of DISC, analyzes the GATT objections thereto, and discusses whether the proposed legislation is in fact GATT-compatible.

To stimulate the export of U.S. manufactured goods, Congress added in 1971 Sections 991 through 997 to the Internal Revenue Code⁷ and granted special tax benefits to qualifying domestic corporations. Departing from U.S. policy that taxed a domestic corporation on its worldwide income, these provisions exempt a DISC from tax on its profits. Instead, the shareholders of a DISC are taxed on a portion of its profits, whether or not actually distributed, with the balance deferred until actually distributed or deemed distributed through disqualification or disposition of the stock. As a result, a DISC is, in part, a "pass through entity" that resembles an S corporation, and, in part, a deferral entity that resembles a foreign corporation.

As originally enacted, the deferral privilege applied to fifty percent of the DISC's *annual* earnings.⁸ In 1976, Congress reduced the deferral privilege to fifty percent of the DISC's *increase* in annual earnings.⁹ In 1982, Congress reduced again the deferral privilege by changing the percentage from 50 percent to 42.5 percent.¹⁰

To qualify as a DISC, a series of initial and ongoing requirements must be met. The initial requirements are highly formalistic, easy to

DAILY TAX REP. (BNA) No. 140, at LL-1 (July 21, 1982). See also DAILY TAX REP. (BNA) No. 141, at LL-1 (July 21, 1982).

⁴ General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. (5) & (6), T.I.A.S. No. 1700 [hereinafter cited as GATT].

⁵ H.R. 3810, 98th Cong., 1st Sess., 129 CONG. REC. S11761-66 (daily ed. Aug. 4, 1983)[hereinafter cited as FSC].

⁶ S. 1804, 98th Cong., 1st Sess., 129 CONG. REC. S11761-66 (daily ed. Aug. 4, 1983)[hereinafter cited as FSC].

⁷ I.R.C. §§ 991-997 (1982).

⁸ I.R.C. § 995(b)(1)(D) (1971).

⁹ I.R.C. § 995(b)(1)(F)(i) (1976).

¹⁰ I.R.C. § 291(a)(4) (1982).

meet, and once met will not require further action or monitoring. They consist of the following:¹¹ (1) the DISC must be a "domestic" corporation; (2) the DISC must have only one class of stock whose par or stated value is at least \$2,500 on each day of the taxable year;¹² (3) the DISC must timely elect DISC status, and all its shareholders must timely consent to DISC status. The ongoing requirements are conceptually easy to meet, require significant annual monitoring, and have traps for the unwary that have resulted in the disqualification of many DISCs. They consist of the following:¹³ (1) at least ninety-five percent of the DISC's gross receipts must be "qualified export receipts," which are receipts from the sale of export property¹⁴ and the yield obtained from investing in qualified export assets;¹⁵ (2) at least ninety-five percent of the DISC's assets must be "qualified export assets," which are primarily receivables from export customers, designated financial instruments, and export property.

Noticeably absent from the list of requirements is the usual indicia of corporate substance, including employees, equipment, an office, or the need to engage actively in business. Most DISCs are "paper" corporations that do not engage in any meaningful amount of activity. Under the normal "arm's-length" pricing standard of I.R.C. Section 482,¹⁶ most DISCs would not be entitled to earn any of their export profits. Recognizing this, Congress enacted "safe-haven" intercompany pricing rules in I.R.C. Section 994 as a shield against the weapon of Section 482.¹⁷ The "safe-haven" intercompany pricing rules allow a DISC to earn the greater of four percent of qualified export receipts from the sale of export property or fifty percent of combined taxable income resulting from such qualified export receipts.¹⁸ Neither method, however, can be applied to the extent that it creates a loss for its related supplier, unless the application of the method is necessary to permit the DISC to recover its costs.¹⁹ Thus, most DISCs, at worst, operate at break-even and, at best, operate at fifty percent of their related supplier's net profit margin.

Of the profit earned by a DISC through the safe-haven pricing

¹¹ I.R.C. § 992(a)(1) (1982). In addition to these statutory requirements, Treasury Regulations have added other requirements, several of which were later held invalid. *See infra* note 12 and accompanying text.

¹² Treas. Reg. § 1.992-1(d)(1), T.D. 7323, 1974-2 C.B. 225, 230 requiring that the capital be "paid in," was held invalid in *Durbin Paper Stock Co. v. Commissioner*, 80 T.C. 252 (1983). *Durbin* also held invalid Treas. Reg. § 1.992-1(a)(b), T.D. 7420, 1976-1 C.B. 210, 211, requiring a DISC to have a separate bank account.

¹³ I.R.C. § 992(a)(1) (1982).

¹⁴ Export property includes products manufactured, produced, grown, or extracted in the United States by persons other than the DISC and sold for use, consumption, or disposition outside the United States.

¹⁵ Qualified export assets are usually the receivables arising from the sale of export property, and specially designated financial instruments in the nature of commercial paper.

¹⁶ I.R.C. § 482 (1982).

¹⁷ I.R.C. § 994 (1982). *See infra* note 18 and accompanying text.

¹⁸ *Id.* § 994(a) (1982).

¹⁹ Treas. Reg. § 1.994-1(e), T.D. 7364, 1975-2 C.B. 315, 320-21.

rules, at least 57.5 percent is deemed distributed to its shareholders and taxed as ordinary income.²⁰ By reason of the incremental rules, the deemed distribution is normally greater, probably in the area of sixty-five to seventy-five percent. For a DISC employing the four percent safe-haven pricing rule, this means approximately 1 to 1.5 percent of export gross receipts is eligible for deferral.

The deferral of income is hampered or eliminated, however, if more than five percent of the DISC's assets do not constitute "qualified export assets."²¹ The asset in which most DISCs first invest is the underlying accounts receivable, which give rise to qualified export receipts. In recent years, the amount of available qualifying accounts receivable has been inadequate to absorb reinvestment of the DISCs deferred profits. As a result, in order to meet the ninety-five percent assets test, DISCs have begun to invest in a few financial instruments that are qualified export assets.

By continuing to meet the ongoing requirements of the DISC legislation, the portion of DISC income deferred will remain so indefinitely. Many companies therefore, treat DISC profits as permanently untaxed. Because of this, net income from export sales is increased by use of a DISC. This, it is argued, constitutes a government subsidy to exporters. It is this allegation that has drawn the objection of GATT members.

In 1972, one year after the enactment of the DISC legislation, the European Community and Canada filed a complaint attacking the DISC as an illegal export subsidy that violates Article XVI:4 of the General Agreement on Tariffs and Trade.²² The United States filed counterclaims against the tax treatment of off-shore income by the Netherlands, Belgium, and France and argued that the effect of those countries not taxing income of foreign subsidiaries (the "territorial system") was substantially the same result accorded DISCs by the United States.²³

After several years of procedural maneuvering, four GATT panels considered these complaints. In November 1976, these panels reported

²⁰ Under the 1982 amendment Congress reduced the deferral privilege under I.R.C. § 995(b)(1)(F)(i) (1982) to 42.5%. Thus, 57.5% of the profit earned by a DISC is deemed distributed to its shareholders.

²¹ See I.R.C. § 992(a)(1)(A) (1982), which requires the DISC, to remain qualified as a DISC, to hold at least 95% of its assets as "qualified assets." The Code defines "qualified export assets" in I.R.C. § 993(b) (1982).

²² Article XVI:4 of GATT reads as follows:

Further, as from 1 January 1958 or the earliest practicable date thereafter, contracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers on the domestic market. Until 31 December 1957 no contracting party shall extend the scope of any such subsidization beyond that existing on 1 January 1955 by the introduction of new, or the extension of existing subsidies.

General Agreement on Tariffs and Trade, done Mr. 10, 1955, 8 U.S.T. 1777, T.I.A.S. No. 3930 (amending the preamble and Parts II & III of GATT, *supra* note 4).

²³ See DAILY TAX REP. (BNA) No. 188, at K-1 (Sept. 29, 1981).

that both DISC and the specified European tax practices were inconsistent with GATT Article XVI:4.²⁴ After much behind-the-scenes maneuvering, the GATT Council adopted in December, 1981 the four panel reports of 1976, but with an important qualifier:

The Council adopts these reports on the understanding that with respect to these cases, and in general, economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities in terms of Article XVI:4 of the General Agreement. It is further understood that Article XVI:4 requires that arm's-length pricing be observed, *i.e.* prices for goods in transactions between exporting enterprises and foreign buyers under their or the same control should for tax purposes be the price which would be charged between independent enterprises acting at arm's-length. Furthermore, Article XVI:4 does not prohibit the adoption of measures to avoid double taxation of foreign source income.²⁵

The effect of this qualifier is to sanction the French, Dutch, and Belgium territorial tax systems as a legitimate method of avoiding double taxation, as long as arm's-length pricing for intercompany transactions was followed. Whether the qualifier also sanctioned DISC was a matter of some disagreement. The European Community did not believe DISCs were sanctioned by the above qualifier. On the other hand, the United States viewed the qualifier as requiring "that the level of taxes assessed on export profits be at least equal to that applied if the country had adopted the territorial system of taxation."²⁶

The Reagan Administration's view that DISC had become a dead issue with GATT caused, in part, the Canadians to reopen the issue before the GATT Subsidies Code Committee.²⁷ Later, the European Community joined Canada at a meeting of the Subsidies Committee of GATT on April 29th and 30th, 1982.²⁸

On June 29, 1982, the GATT Council met to consider the December, 1981 decision and the views of the various countries on the meaning of that decision. It has been reported that a GATT official present at the meeting stated that "the United States was the only country to pretend that the December understanding had nothing to do with DISC."²⁹

At the meeting, Deputy U.S. Trade Representative David R. MacDonald presented the U.S. response to the "new" attack on DISC. The response was "very long and complicated," resulting in a request by the GATT Council that the United States submit its views in writing.³⁰ The

²⁴ For the text of these panel reports of Nov. 2, 1976, L/4422 (DISC), L/4423 (France), L/4424 (Belgium) and L/4425 (Netherlands), see 13 TAX NOTES 1251 (1981).

²⁵ See 13 TAX NOTES 1485, 1485 (1981).

²⁶ DAILY TAX REP. (BNA) No. 240, at G-6 (Dec. 15, 1981) (quoting U.S. Ambassador Michael Smith).

²⁷ See *id.* No. 72, at G-1 (Apr. 14, 1982).

²⁸ See *id.* No. 87, at LL-1 (May 5, 1982).

²⁹ See 16 TAX NOTES 81, 81 (1982).

³⁰ See *id.* See also 16 TAX NOTES 269, 269-71 (1982).

main point of the written submission is that more taxes are collected by the United States under the "global" system, as modified by DISC, than are collected under the "territorial" system sanctioned for France, Belgium, and the Netherlands. The European Community viewed this argument as unpersuasive because DISCs do not apply to "export activities outside the territory of the [United States]."³¹ Apparently impatient with the lack of progress on this matter, the European Community asked the United States for compensatory damages of \$2.3 billion (the European Community's share of alleged worldwide damages of \$10 billion, computed from the Treasury Department's "1979 Report on DISC," published in 1981).³² Although no action was taken by the GATT Council on the compensatory damage request, the United States found itself increasingly isolated in the sixty-four member GATT body.³³

As a result of the pressure, Deputy U.S. Trade Representative MacDonald announced, on July 27, 1982, that his office was considering a "partially territorial" approach as a DISC substitute to end the GATT battle.³⁴ Two days later, his office released a confidential June 8, 1979 memorandum indicating that the Carter Administration, in a private meeting of officials of the U.S. Treasury, the European Communities, and GATT had conceded that DISC is GATT-illegal.³⁵ On October 1, 1982, the United States officially told the GATT Council that the Reagan Administration would ask Congress to revise the DISC legislation to address the concerns of other GATT members over the controversial export tax incentive.³⁶ This announcement was welcomed by many GATT members.

In the following months, the Treasury began drafting replacement legislation, and privately circulated the proposal in the business community.³⁷ In addition, Senator David L. Boren reintroduced his proposal for an offshore entity as an alternative to DISC.³⁸ Meanwhile, Senate Finance Committee Chairman Dole directed the committee staff to draft

³¹ See DAILY TAX REP. (BNA) No. 135, at LL-2 (July 14, 1982) (quoting European Community Negotiator Roderick Abbott). At about the same time, Senate Finance Committee member, David L. Boren (D-Okla), introduced the Export Sales Corporation Act of 1982, S. 2708, 97th Cong., 2d Sess., 128 CONG. REC. 57895-98 (daily ed. July 1, 1982). This bill, in direct response to the GATT issue, would have made DISC an offshore entity and thus technically closer to the territorial system. See 16 TAX NOTES 271 (1982). Similar legislation was introduced in the House by Ways and Means Committee member Rep. Bill Frenzel as H.R. 5179, 97th Cong., 1st Sess., 127 CONG. REC. H9437 (daily ed. Dec. 11, 1981).

³² See DAILY TAX REP. (BNA) No. 140, at LL-1 (July 21, 1982).

³³ See *id.* No. 141, at LL-1 (July 22, 1982).

³⁴ See *id.* No. 144, at LL-3 (July 27, 1982). The MacDonald plan has attracted little support since its announcement, and has been viewed by some people as just as GATT-illegal as DISC. See 17 TAX NOTES 157 (1982).

³⁵ See 16 TAX NOTES 453 (1982).

³⁶ See DAILY TAX REP. (BNA) No. 191, at LL-1 (Oct. 1, 1982).

³⁷ See Wall St. J., Feb. 22, 1983, at 10, col. 2.

³⁸ See DAILY TAX REP. (BNA) No. 21, at LL-1 (Jan. 31, 1983), which describes the Boren bill (S. 28) introduced on Jan. 26, 1983.

its own proposal.³⁹ Representative Guy Vander Jagt, a member of the House Ways and Means Committee, also expressed interest in a legislative solution.⁴⁰ With an initial flurry of activity, but with little visible progress, the European Community renewed, on July 18, 1983, its call for the appointment of a working party to assess damages caused by DISCs, and received assurance by the U.S. Trade representative that the Reagan Administration was doing all it could to convince Congress to amend DISC and make it compatible with GATT rules.⁴¹ With the introduction of proposed legislation in the House and Senate two weeks later, the matter seemed once again to have quieted down in GATT. It would, however, be unwise to assume that the final chapter on the GATT issue is nearly complete.

The Foreign Sales Corporation (FSC)⁴² resembles a DISC, a result that would be expected by legislation attempting merely to make existing law GATT-compatible. The DISC rules are highly formalistic and generally lacking in substance. The FSC rules are even more formalistic, but appear to contain a bit more substance. A FSC must meet a series of requirements in order to qualify for the eligible benefits. These requirements again fall into the two categories of initial and ongoing requirements.

The initial requirements are highly formalistic, relatively simple to comply with, and once met will generally continue to be met without significant monitoring on an annual basis. The initial requirements are as follows:⁴³ (1) the FSC must be a foreign corporation (including an association taxable as a corporation);⁴⁴ (2) the FSC cannot have more than twenty-five shareholders at any time during the taxable year; (3) the FSC cannot have any preferred stock outstanding during the taxable year; (4) during the taxable year, the FSC must "maintain an office" located outside the United States;⁴⁵ (5) during the taxable year, the FSC must maintain permanent books of account of the FSC at its office outside the United States;⁴⁶ (6) during the taxable year, the FSC must maintain, at a location within the United States, records required of the

³⁹ *Id.*

⁴⁰ *See id.* No. 26, at LL-1 (Feb. 7, 1983) (describing Rep. Vander Jagt's proposal for a legislative tax substitute).

⁴¹ *See id.* No. 138, at LL-1 (July 18, 1983).

⁴² *See supra* note 6. An FSC should not be confused with a FISC, which is a Foreign International Sales Corporation subsidiary of a DISC under I.R.C. §§ 993-995 (1982).

⁴³ *See* proposed I.R.C. § 992(a), *supra* note 6.

⁴⁴ For this purpose, "foreign" is defined to mean created or organized under the laws of any foreign country or under the laws applicable to any possession of the United States.

⁴⁵ The meaning of this phrase is unclear. Does a FSC need to have its own employees to meet this test? Can a FSC share space already owned or leased by a related entity, or must the FSC lease its own space? Can a FSC meet this requirement by sharing space with its attorney or its accountant?

⁴⁶ Does "maintain a set of permanent books of account" mean actually generate those books at the foreign "office" of the FSC, or can they be generated elsewhere (*e.g.*, at the parent company home office in the U.S.) and sent there?

FSC under I.R.C. Section 6001;⁴⁷ (7) at all times during the taxable year, the FSC must have a board of directors that includes at least one individual who is not a resident of the United States;⁴⁸ (8) the FSC cannot be a member of any controlled group of corporations of which a DISC is a member; and (9) the FSC must timely elect FSC status.

The ongoing requirements, which require significant monitoring and which must be met annually, are that the FSC must be "managed" outside the United States, and certain "economic processes" of the FSC must take place outside the United States.⁴⁹ In order to be considered as "managed" outside the United States, the FSC must meet the following three requirements: (1) all meetings of the board of directors and all meetings of the shareholders are outside the United States;⁵⁰ (2) the principal bank account of the FSC is maintained outside the United States at all times during the taxable year; and (3) all dividends, legal and accounting fees, and salaries of officers and members of the board of directors of the FSC are disbursed during the taxable year out of bank accounts (not necessarily the principal bank account) of the FSC maintained outside the United States.

The economic processes are vaguely defined as the solicitation (other than advertising), the negotiation, or the making of the contract relating to a qualified transaction. Surrounding this vague definition is an additional requirement that a significant percentage of the costs thereof must be incurred by the FSC. As a general rule, the FSC must incur at least fifty percent of the *total* of the costs for the following five activities: (1) advertising and sales promotion; (2) the processing of customer orders and the arranging for delivery (outside the United States) of the export property; (3) the transportation from the time of acquisition by the FSC to the delivery to the customer; (4) the determination and transmittal of a final invoice or statement of account and the receipt of payment; and (5) the assumption of credit risk. As an alternative to fifty

⁴⁷ The relationship of this requirement to the preceding "permanent books of account" requirement is unclear. The requirements of I.R.C. § 6001 (1982) to "keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe," would appear to be broad enough to include "permanent books of account" and hence may require more record keeping in the U.S. than at the foreign office of the FSC.

⁴⁸ Presumably, the phrase "not a resident of the United States" would allow a U.S. citizen who is a *bona fide* resident of a foreign country qualifying for the benefits of I.R.C. § 911 (1982) to be eligible. However, an alien who is "deemed" to be a resident of the U.S., under recently introduced legislation (H.R. 3475, 98th Cong., 1st Sess., 129 CONG. REC. H4880, 4884 (daily ed. June 30, 1983)), would presumably fail this test. Because the "not a resident" test must be met at "all times" during the taxable year, prudence would dictate that multiple nonresidents be on the Board in case one happens to gain U.S. resident status.

⁴⁹ See proposed I.R.C. § 924(c)-(e), *supra* note 6.

⁵⁰ Literally read, the meetings need not take place in the foreign country where the office of the FSC is located. Such meetings, therefore, can presumably take place anywhere else in the world. Will this give rise to a legitimate tax deductible foreign vacation of the type that the foreign convention rules of I.R.C. § 274(h)(1982) are attempting to prevent?

percent of the total of the above five costs, the FSC can incur eighty-five percent of each of any two of the five categories.

If the initial and ongoing requirements are satisfied, certain gross receipts of the FSC take on the status of "foreign trading gross receipts." "Foreign trading gross receipts" is a key term in applying the safe-haven intercompany pricing rules for determining taxable income of the FSC. They are defined as gross receipts from any of the following five categories: (1) the sale, exchange, or other disposition of "export property";⁵¹ (2) the lease or rental of "export property" that is used by the lessee outside the United States; (3) the performance of services that are related and subsidiary to the sale, exchange, lease, rental, or other disposition of "export property" by the FSC; (4) the performance of engineering or architectural services for construction projects located outside the United States; and (5) the performance of managerial services in furtherance of the production of foreign export trading gross receipts.⁵²

For the activities underlying the foreign trading gross receipts, a FSC is permitted to adopt one of three transfer pricing rules similar to those available to a DISC under current law. If the FSC meets the "economic processes outside of the United States" activities test,⁵³ it can choose between the "arm's-length" pricing standard of I.R.C. Section 482⁵⁴ or one of two safe-haven rules. The two special safe-haven rules deal with sales by a related person to a FSC, but not sales by a FSC to a related person, and consist of taxable income derived from the sale of export property equal to 1.83 percent of foreign trading gross receipts, or taxable income equal to twenty-three percent of the combined taxable income of the FSC and its related supplier, attributable to foreign trading gross receipts.⁵⁵

Once the taxable income of the FSC is determined under either the arm's-length standard or the safe-haven intercompany pricing rule, it must be modified further to derive the portion that is exempt from U.S. tax. Of the FSC income determined under the safe-haven intercompany pricing rules, seventeen twenty-thirds is deemed to be exempt foreign trade income. If the taxable income of the FSC is determined under the "arm's-length" rules, then thirty-four percent of such taxable income is deemed to be exempt foreign taxable income. If the safe-haven transfer pricing percentages are combined with the exempt foreign trade income percentages, the result is that either 1.35 percent of foreign trading gross receipts is exempt, or seventeen percent of the combined taxable income

⁵¹ See *supra* note 14.

⁵² See proposed I.R.C. § 924(a), *supra* note 6.

⁵³ See *supra* note 49 and accompanying text. Strangely, even though the FSC can use the alternative 85% test (*i.e.*, 85% of each of any two of the five categories), it must nevertheless perform all five categories to be eligible for the safe-haven pricing rules. See proposed I.R.C. § 925(c)(1), *supra* note 6.

⁵⁴ See, *e.g.*, Treas. Reg. § 1.482-2 (1968).

⁵⁵ See proposed I.R.C. § 925(a), *supra* note 6.

from foreign trading gross receipts is exempt.⁵⁶

Under the DISC safe-haven rules of I.R.C. Section 994,⁵⁷ those with an operating profit margin of less than eight percent would use the four percent gross receipts method, but those with greater than an eight percent operating profit margin would use the fifty percent combined taxable method. This "eight percent operating profit margin" rule of thumb holds true under the FSC safe-haven pricing rules, as illustrated below:

Foreign Trading Gross Receipts	\$100.00
Operating Profit Margin (8%)	\$ 8.00
17% × Operating Profit (\$8)	\$ 1.36
1.35% × Gross Receipts (\$100)	\$ 1.35

If the operating profit margin falls below eight percent, the 1.35 percent gross receipts method yields a greater amount of exempt income.

Under the DISC rule, the four percent gross receipts method was limited in amount to *total* combined taxable income. This is commonly referred to as the "no-loss" rule.⁵⁸ There is a similar no-loss rule that prohibits the 1.35 percent gross receipts method result from exceeding twice the combined taxable income.⁵⁹

Exempt foreign trade income is treated as foreign source income not effectively connected with a U.S. trade or business. All other income of the FSC, including the nonexempt portion of foreign trade income, interest, dividends, royalties and other investment income, and carrying charges received by the FSC, is treated as income effectively connected with a trade or business conducted through a permanent establishment in the United States. The nonexempt portion of foreign trade income is deemed to be U.S. source income. The source of investment income and carrying charges is determined under the general source rules of I.R.C. Sections 861 through 863.⁶⁰ As a result, the FSC must pay U.S. tax on the nonexempt income. In making the determination of taxable income for this purpose, any deductions of the FSC must be allocated to the exempt income; such deductions are effectively being denied.

Any distributions by a FSC to its shareholders are treated first as coming from exempt earnings and profits of the FSC to the extent thereof. Thereafter, distributions come from other earnings and profits.⁶¹ Domestic corporate shareholders are allowed a hundred percent dividends received deduction for dividends attributable to foreign trading

⁵⁶ See *id.* at I.R.C. § 923(a)(3).

⁵⁷ See *supra* note 18 and accompanying text.

⁵⁸ See Treas. Reg. § 1.994-1(e) which is entitled "Limitation on DISC Income ('no loss rule')," *supra* note 19.

⁵⁹ See proposed I.R.C. § 925(d), *supra* note 6.

⁶⁰ I.R.C. §§ 861-863 (1982). Because all three categories of income (non-exempt foreign trading income, investment income and carrying charges) are treated as effectively connected with a U.S. business, all three are subject to the normal corporate income tax under I.R.C. § 11 (1982) by reason of I.R.C. § 882 (1982), whether U.S. source or foreign source. It is unclear why the Act singles out only non-exempt foreign trading income as U.S. income, and why a foreign tax credit is denied for such income. See proposed I.R.C. §§ 921(d) & 906, *supra* note 6.

⁶¹ See proposed I.R.C. § 926(a)(1) & (2), *supra* note 6.

income, regardless of whether the foreign trading income is exempt.⁶² Distributions, however, attributable to income of the FSC from interest and dividends, are not eligible for the dividends received deduction. This amount carries with it any deemed paid foreign income taxes, but a credit is denied for any foreign income taxes attributable to foreign trading income.⁶³

The general effective date for the FSC legislation is December 31, 1983. In hearings conducted by the Senate Finance Committee on February 3, 1984, Ronald A. Pearlman, Deputy Assistant Secretary for Tax Policy, Department of Treasury, testified that the Reagan Administration proposes that the general effective date be changed from December 31, 1983 to December 31, 1984. The rationale for the change is that "[i]t is important that the general effective date of the Bill be prospective." Whether this legislation will in fact be enacted this year is a matter of some doubt. Some of the reasons for the doubt are as follows: (1) the lack of congressional interest in the subject matter, especially on the part of House Ways and Means Chairman Rostenkowski; (2) a great deal of congressional staff time is occupied by the major rewrite of Subchapter C of the Code, which deals with the taxation of corporations and their shareholders;⁶⁴ (3) the Bill is designed to be Revenue neutral and, therefore, is of little interest to those concerned with the huge budget deficits; and (4) numerous other tax bills pending will cause this Bill to have a lower priority on the congressional calendar for the remaining days of this session.

Virtually all of the reasons above can be categorized either as lack of interest or too busy. The too busy category is a convenient excuse rather than a real issue. One need only look at the last few years when Congress hammered out four major tax bills (ERTA, TEFRA, The Installment Sales Revision Act, and the Subchapter S Revision Act) to question Congress' ability to enact major legislation in a short time frame. It appears, therefore, that the real issue is one of interest in the subject. This, in turn, is a function of how interested the Reagan Administration is in having the legislation enacted. The Reagan Administration has shown an ability to enact legislation that it wants enacted. The Administration's interest level is, in turn, affected by the amount of pressure brought to bear at GATT. Having committed to GATT more than one year ago to enact the legislation, the Reagan Administration's credibility before GATT is on the line. Thus, there is a reasonable possibility that this legislation will be enacted in 1984.

More important than when the legislation will be enacted is how it will be interpreted when it is enacted. Many DISCs were disqualified by

⁶² See S. 1804, *supra* note 6 at § 2(b) (amending I.R.C. § 245 (1982)).

⁶³ See proposed I.R.C. § 921(c), *supra* note 6.

⁶⁴ The extent of time being spent on the major rewrite of subchapter C can easily be appreciated by reading the summary reprinted in DAILY TAX REP. (BNA) No. 187 (Sept. 26, 1983).

the IRS for seemingly minor technical violations. In some cases, the rationale for disqualifying the DISC was later found inappropriate when the Treasury Regulations were held invalid.⁶⁵ In other instances, the validity of the regulations was upheld.⁶⁶

As complex as they are, compliance with the DISC rules is easier than compliance with the FSC rules. Part of the reason for this has to do with the introduction of a foreign jurisdiction in connection with the FSC rules. It is one thing to enact rules involving only the U.S. jurisdiction; it is quite another to involve foreign countries and not expect additional complications.

The most complex of the qualifications tests is the "economic process outside the United States" test.⁶⁷ Proposed I.R.C. Section 924(d) mentions twice that some of the requirements of the FSC can be met by "any person acting under a contract with such corporation."⁶⁸ Because at least some of the processes must be performed outside the United States, if an FSC can "contract away" some or all of these requirements, it will likely have to do so, in part, with a related foreign corporation. It is not clear whether this means that the economic process outside the United States boils down to the appropriate amount of intercompany charges for the "contracted away" services to a related foreign corporation. If so, the issue is likely to become complicated because it involves other than U.S. jurisdiction.

There is, of course, the ultimate question whether the legislation in its present form will satisfy GATT. Because GATT approval of the territorial method of taxation is dependent upon arm's-length pricing between the parent and its foreign subsidiary, inclusion of the safe-haven pricing alternatives may not satisfy GATT standards.

⁶⁵ See, e.g., *supra* note 12 and accompanying text.

⁶⁶ See, e.g., *CWT Farms, Inc. v. Commissioner*, 79 T.C. 86 (1982) (upholding the validity of Treas. Reg. § 1.995-1(a)(5), T.D. 7324, 1974-2 C.B. 240, 243 and Treas. Reg. § 1.246-4, T.D. 7283, 1973-2 C.B. 79, 80).

⁶⁷ See *supra* note 49 and accompanying text.

⁶⁸ See proposed I.R.C. § 924(d), *supra* note 6.