NOTE

CHANGES IN THE 1976 TAX REFORM ACT IN THE TREATMENT OF DISCS: STREAMLINING THE DISC PROVISIONS

I. INTRODUCTION

The creation of the Domestic International Sales Corporation (DISC)[1] method of deferral of tax on export income in 1971 was an attempt by Congress to use tax incentives in order to solve an ever worsening balance of payments deficit.[2] The DISC legislation was part of a general effort by Congress, in the late 1960's and early 1970's, to bolster the United States economy.[3]

The DISC provisions allow a corporation, manufacturing goods in the United States for distribution abroad, to defer taxation on up to half of the income earned from such exports. The corporation forms a DISC subsidiary to handle its export sales function. The DISC entity would not be taxed directly; instead a certain amount of the DISC's income would be deemed to have been distributed to its shareholders in the year earned and is taxed to them individually.[4] It was hoped that DISCs would put American manufacturers in a more competitive position to sell their products overseas.[5] Con-

1. I.R.C. §§ 991-997, *as amended by* Tax Reform Act of 1976, Pub. L. No. 94-455, §§ 1061-1063, 1064, (adding I.R.C. § 999), 1101, 90 Stat. 1649-53, 1655-60.

2. The balance of payments deficit climbed to a record $22.1 billion in 1971, up from $18.3 billion in 1970. BALANCE OF PAYMENTS REP. (CCH) ¶ 195 (1972).

3. The Treasury Department has never contended that the DISC, even in its originally proposed form, would be a complete solution to the balance of payments problem:

> We hope [this legislation] will help stimulate corporate management to look harder at export markets and to look harder at them over a period of time and devote additional effort, time, talent to those markets. But this is not a proposal which is suddenly going to relieve us of all of our trade problems and suddenly produce all by itself a glorious expansion in exports and solve our balance-of-payments problems. This is a more modest and limited step in a range of efforts that have to be taken over time to make American industry more competitive and more export minded.

Hearings on Tariff and Trade Proposals Before the House Comm. on Ways and Means, 91st Cong., 2d Sess., pt. 2, at 535 (1970) (remarks of Paul A. Volcker, Under Secretary for Monetary Affairs, U.S. Treasury Dep't) [hereinafter cited as *Hearings on Tariff and Trade Proposals*].

4. I.R.C. § 995.

5. [T]he committee agrees with the House that it is important to provide tax incentives for U.S. firms to increase their exports. This is important not only because of its stimulative effect but also to remove a present disadvantage of U.S. companies engaged in export activities through domestic corporations.

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gress intended that DISCs would generally stimulate the flow of United States dollars back into this country from abroad.

The DISC incentive has been criticized for its large costs in terms of lost tax revenues,[6] and for the fact that it may be adding new forms of discrimination among taxpayers to an already discriminatory tax system.[7] It is to these criticisms that the Tax Reform Act of 1976[8] attempted to respond.

This Note will examine the changes made in the DISC scheme by the Tax Reform Act of 1976 (1976 Act). These changes will be analyzed in the context of the DISC law as it existed before the passage of the 1976 Act, and the possible effects of these changes will be explored.

II. RATIONALE BEHIND DISC ENACTMENT

The original DISC legislation was part of a wide-ranging response to the general slump in the United States economy in 1971.[9] Traditional economic measures seemed ineffective in stimulating the economy, and Congress responded with an attack on all fronts to correct the problem.[10]

The DISC legislation was aimed at dealing specifically with the ever worsening balance of payments position and trade deficit. A balance of payments deficit has plagued the United States since the

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SENATE COMM. ON FINANCE, REPORT ON PUB. L. 92-178, S. REP. No. 92-437, 92d Cong., 1st Sess. 90, *reprinted in* [1971] U.S. CODE CONG. & AD. NEWS 1918, 1996.

6. The House Ways and Means Committee estimated lost revenues of $1.3 billion in 1975, and $1.4 billion in 1976. H.R. REP. No. 94-658, 94th Cong., 2d Sess. 263, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 2897, 3159 [hereinafter cited as WAYS AND MEANS REPORT].

7. See notes 20-23 *infra* and accompanying text.

8. Pub. L. No. 94-455, §§ 1061-1064, 1101, 90 Stat. 1649-53, 1655-60 (1976).

9. The Revenue Act of 1971, Pub. L. No. 92-178, §§ 501-507, 85 Stat. 497, 535-53 (adding I.R.C. §§ 991-997). The Act also included such measures as the seven percent investment tax credit, repeal of certain excise taxes on autos and trucks, and some liberalization of the standard deduction scheme.

10. The House Report stated Congress's reasons for DISC legislation as follows:

> Your committee believes that this bill is necessary because the performance of the economy in recent months has been unsatisfactory. The growth in our gross national product has been small, unemployment has remained too high, and capital goods expenditures have hardly grown at all. Despite these factors, which would usually point toward deflation, we have been unable to shake the persistent inflationary trend in prices. All this has been compounded by our serious adverse balance of trade and the accompanying crisis in the position of the dollar abroad.

HOUSE COMM. ON WAYS AND MEANS, REPORT ON PUB. L. 92-178, H.R. REP. No. 92-533, 92d Cong., 1st Sess. 3, *reprinted in* [1971] U.S. CODE CONG. & AD. NEWS 1825, 1827 [hereinafter cited as 1971 REPORT].

early 1950's.[11] Voluntary programs such as the Voluntary Cooperation Program,[12] and mandatory taxes relating to specific causes of the currency drain, such as the Interest Equalization Tax,[13] were created. These measures met with some success within narrow limits.[14] In 1971, however, worsening inflation and unemployment problems, coupled with increased war expenditures, combined to produce a payments deficit of gargantuan proportions.[15]

Congress recognized that poor economic conditions were not the only cause of the deteriorating balance of payments and trade deficits. Current tax policies were blamed for not encouraging investment in a manner that would enable American business to compete more effectively in foreign markets.

DISC benefits had never been considered as a complete solution to the balance of payments problem.[16] The Treasury Department did believe, however, that in addition to increasing exports, DISC benefits would stimulate corporate management to devote additional time, effort, and talent toward the identification and development of new international markets.[17]

The DISC benefits were also viewed as a method of increasing corporate efficiency by simplifying corporate structure. In order to avoid American taxation of foreign earned income, corporations were forced to incorporate subsidiaries in the countries in which they sold. This resulted in much duplication of corporate functions, multiple records, poor control, and added waste due to increased corporate layering. The DISC setup negated many of the benefits

11. Europe's recovery and return to a competitive trade position in the 1950's helped eliminate huge balance of payments surpluses which developed out of the late 1940's rebuilding of Europe, and created huge payments deficits averaging $3.7 billion annually in the late 1950's. Lancaster, *Taxes and the Balance of Payments,* 23 Ark. L. Rev. 378, 384 (1970).

12. This program, instituted in 1965, was an attempt by President Lyndon B. Johnson to encourage American companies to cut back on foreign investment and to finance foreign investment in foreign capital markets, where the interest rates were higher than in American markets. In addition, American companies were asked to forego these higher foreign interest rates on their earnings in favor of repatriating foreign earnings.

13. Interest Equalization Tax Act, Pub. L. No. 88-563, §§ 1-2, 78 Stat. 809-43 (1964) (adding I.R.C. §§ 4911-4931). The tax was a flat fifteen percent tax on foreign stock purchases for all non-bank United States lenders and purchasers. The tax on loans was graduated and linked to the time of maturity of the loans. It was hoped that, because American lenders would pass the tax on to foreign borrowers, the interest differential would be equalized. Lancaster, *supra* note 11, at 387-88.

14. *Id.* at 390.

15. See note 2 *supra.*

16. Note, *Domestic International Sales Corporations, A Tax Incentive for Exporters,* 56 Minn. L. Rev. 407, 411 (1972).

17. *Hearings on Tariff and Trade Proposals, supra* note 3, at 535.

of foreign incorporation by providing an alternative method to shield export income from current United States taxation. An American corporation no longer had to sell through a foreign incorporated subsidiary, and had a greater incentive to manufacture products sold overseas in the United States. Costly duplication of effort in order to satisfy foreign legal, accounting, or tax requirements could also be avoided.[18]

A problem with any tax incentive based on deferral, such as DISCs, is that its success is measured by the amount of revenue it fails to generate. When certain activity is desired, such as an increase in exports, the only effective use of the tax laws as an inducement is through deferrals, as in the DISC plan, or through credits against tax otherwise owing from that activity. In addition, the credit or deferral program, must be structured so that it is more advantageous for those who are affected by it to choose not to pay the tax. Thus, the success of DISCs is measured by the amount of tax revenues lost to the government.[19]

From the onset there has been vocal opposition to enactment of DISC benefits. Representatives Gibbons and Corman feared that DISC benefits would create a new form of tax discrimination against companies producing solely for the domestic market, and that the benefits allowed exceeded the measures necessary to equalize the tax advantages for foreign subsidiaries. They believed that the anticipated increase in exports would not justify the estimated loss of tax revenues. In addition, since the DISC could loan its deferral income to the parent company,[20] the deferral could in reality become an exemption.[21] Professor Alan Schenk suggested that the proper way to counteract the benefits of sale through foreign subsidiaries was to tax the foreign subsidiary.[22] Representatives Corman and Gibbons also criticized the fact that all export income, and not just the increased export income, would be subject to DISC benefits. This, it was argued, would result in a windfall for pre-existing exporters. The Treasury Department countered that without this ap-

18. Bagley, *A DISC in Your Future*, 48 TAXES 548, 554-55 (1970).

19. Lancaster, *supra* note 11, at 408-09.

20. See notes 94-102 *infra* and accompanying text.

21. HOUSE COMM. ON WAYS AND MEANS, REPORT ON TRADE ACT OF 1970, H.R. REP. No. 91-1435, 91st Cong., 2d Sess. 180, 180-85 (1970) (dissenting views of Reps. James C. Corman and Sam M. Gibbons) [hereinafter cited as 1970 REPORT].

22. *Hearings on Tariff and Trade Proposals, supra* note 3, pt. 9, at 2589 (statement of Professor Alan Schenk).

proach it would be even more difficult for American companies to compete in international markets.[23]

III. ORGANIZING A DISC

Rules for forming a DISC were set out in section 992 of the Internal Revenue Code. Section 992 was designed to provide a simple and straight forward means of organizing a DISC. A corportion that meets the simple test provided by this section will be treated as a separate corporation for tax purposes and will qualify as a DISC. This is so even if the corporation would not have been treated as such but for the DISC provisions.[24] The requirement as to place of incorporation provides much leeway. The DISC may be incorporated in any one of the fifty states or the District of Columbia,[25] but not in a possession of the United States.[26]

A DISC may have only one class of stock issued and outstanding.[27] A minimum capital of $2,500 must be maintained on each day of the DISC's taxable year. The minimum capital is measured by either the par value or the stated value of the DISC stock.[28] In addition, the amount of cash or other property paid in must also total $2,500.[29] Individuals, corporations, partnerships, trusts and estates, nonresident aliens, and foreign corporations may own stock in a DISC.[30]

The existence of a DISC in corporate form is essential, and an "association taxable as a corporation" under section 7701(a)(3) of the Internal Revenue Code will not qualify.[31] However, except for the rigorous requirement that the DISC be a separate corporate entity, the Internal Revenue Code requirements relating to separate corporate substance are greatly relaxed. A DISC must have its own bank account and separate corporate records, but it need not hire employees, maintain an inventory, or do its own billings and collections.[32] A DISC may either act as a commission agent by making export sales on behalf of its parent, or it may resell goods for export

23. 1970 REPORT, *supra* note 21, at 184.
24. Treas. Reg. § 1.992-1(a) (1976).
25. I.R.C. § 992(a)(1); Treas. Reg. § 1.992-1(a)(1) (1976).
26. Treas. Reg. § 1.992-1(a) (1976).
27. I.R.C. § 992(a)(1)(C); Treas. Reg. § 1.992-1(d) (1976).
28. *Id.*
29. Treas. Reg. § 1.992-1(d) (1976).
30. U.S. DEP'T OF THE TREASURY, DOMESTIC INTERNATIONAL SALES CORPORATIONS, A HANDBOOK FOR EXPORTERS III B (1972).
31. Treas. Reg. § 1.992-1(d) (1976).
32. Rev. Rul. 72-166, 1972-1 C.B. 220.

which it has purchased from the parent. The former approach allows the parent's sales force to solicit orders in the name of the parent, while the latter approach requires the parent's sales force to solicit in the name of the DISC.[33] From an organizational viewpoint, most domestic producers/exporters will elect to segregate their export sales function in a wholly-owned subsidiary DISC. A corporation exclusively engaged in the export sales business may, however, simply convert its existing organization to a DISC.[34]

To be treated as a DISC, a corporation must file an election with the Internal Revenue Service.[35] Such election must be within the first ninety days of the taxable year in which DISC treatment is desired.[36] The election will continue for all subsequent years in which the corporation qualifies for DISC treatment, unless specifically revoked by action of the shareholders. If, however, the corporation fails to qualify for five consecutive years, the DISC election will terminate by operation of law.[37]

The election, in order to be effective, must be consented to in writing by every person who is a stockholder as of the beginning of the first taxable year that the election is effective.[38] Once a consent is made, it is binding on the shareholders and may not be withdrawn.[39] Such consent is also binding on all transferees, by whatever means, of the shareholder.[40] These provisions prevent abuse of the consent privilege by a shareholder threatening to withdraw consent. In addition, not requiring consent of transferee shareholders prevents the accidental loss of DISC status due to the failure of a transferee to file a timely election. Thus, a potentially dangerous and expensive trap is avoided.[41]

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33. *Id.*

34. Hill & Replogle, *The Wonderful World of DISC*, 25 OKLA. L. REV. 381, 383 (1972).

35. I.R.C. § 992(a)(1)(D).

36. *Id.* § 992(b)(1). For method of making election, see Rev. Proc. 72-12, 1972-1 C.B. 733 and Treas. Reg. § 1.992-2 (1976).

37. I.R.C. § 992(b)(3)(B).

38. Treas. Reg. § 1.992-2(b) (1976).

39. *Id.* § 1.992-2(c) (1976).

40. *Id.* There are two narrowly defined exceptions to this rule:

(1) shares transferred prior to the first day of the first year of the DISC's election before the transferring shareholder consents, and,

(2) transfers on or before the 90th day of the first taxable year of DISC election if the transferring shareholder has not consented.

In these cases the transferee may file a consent. Treas. Reg. § 1.992-2(c) (1976).

41. See notes 135-39 *infra* and accompanying text.

IV. *QUALIFIED EXPORT RECEIPTS*

A. *Ninety-Five Percent Requirement*

The backbone of the DISC scheme is the requirement that ninety-five percent of the DISC's gross receipts be characterized as "qualified export receipts."[42] This test is designed to prevent the use of the DISC entity as a vehicle for camouflaging transactions that do not really result in the export of goods or services. Gross receipts of DISCs are defined as the total receipts from the sale, lease, or rental in the ordinary course of trade or business, and gross income from all other sources.[43] The definition of gross receipts further provides that if the DISC sells or leases export property as a commission agent, the gross receipts of its parent may be included, for the purpose of the ninety-five percent test, as gross receipts of the DISC.[44]

While the ninety-five percent test exists primarily to prevent abuse of the DISC provisions by persons to whom Congress did not intend to extend DISC benefits, there is always the possibility that an unforeseen event or lack of familiarity with the DISC laws will cause this test to fail. Congress specifically provided the deficiency distribution as a means of avoiding this trap in certain specified situations.[45] There are also similar provisions if the ninety-five percent of qualified export assets test is not met.[46]

A DISC which fails to meet the receipts and/or assets tests may make a distribution equal to the taxable income arising from transactions resulting in the nonqualifying receipts and the fair market value of nonqualifying assets.[47] The distribution must be made pro rata to all shareholders and must be specifically designated as a deficiency distribution.[48] The taxpayer has the burden of showing a reasonable cause for failure to meet the receipts and/or assets tests.[49] Events specifically referred to as meeting the reasonable cause requirement are blocked currency, expropriation of property by a foreign government, a section 482 adjustment of income, an unantici-

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42. I.R.C. § 992(a)(1)(A).
43. *Id.* § 993(f).
44. *Id.* § 993(a)(1).
45. *Id.* § 992(c); Treas. Reg. § 1.992-3 (1976). See notes 112-34 *infra* and accompanying text.
46. I.R.C. § 992(c).
47. *Id.* §§ 992(c)(1)(A)-992(c)(1)(C); Treas. Reg. § 1.992-3(b)(2) (1976).
48. Treas. Reg. §§ 1.992-3(a)(3) to -3(a)(4) (1976).
49. I.R.C. § 992(c)(2)(A).

pated insurance recovery, or a reasonable uncertainty as to what constitutes a qualified export asset or receipt.[50] Reasonable cause will be assumed if the distribution is made within eight and one-half months of the end of the DISC's taxable year, provided that at least seventy percent of the DISC's receipts were qualified export receipts and seventy percent of its assets were qualified export assets for the taxable year.[51] Thus, the possibility of a chance variation in receipts or assets disqualifying the DISC is avoided.

B. Included Property

In order to qualify for DISC treatment, gross receipts of the DISC must fall within one of eight exclusive categories. These are: (1) proceeds from the sale of export property, (2) proceeds from the lease or license of export property, (3) proceeds from the sale of qualified export assets, (4) proceeds from related and subsidiary services, (5) dividend income, (6) proceeds from performing engineering and architectural services, (7) proceeds from performing managerial services, and (8) interest income.[52]

Sales of qualified export property[53] must be made by a DISC on its own behalf or as a sales commission agent, whether or not such person was a related supplier.[54] The DISC must achieve its DISC status prior to the shipment of the property or no receipts from that transaction will be qualified export receipts in any taxable year.[55] Thus, receipts from an installment sale will not qualify unless the corporation was a DISC at time of shipment.[56] The property must be manufactured, produced, grown, or extracted in the United States by a person other than a DISC,[57] and it may not undergo additional manufacturing outside the United States.[58] In addition, no more than fifty percent of the fair market value of the property may be attributed to articles imported into the United States.[59] The property must be held primarily for sale, lease, or rental in the ordinary course of trade or business, and must be for use, consump-

50. Treas. Reg. § 1.992-3(c)(2) (1976).
51. I.R.C. § 992(c)(3).
52. *Id.* § 993(a)(1).
53. *Id.* § 993(a)(1)(A).
54. Proposed Treas. Reg. § 1.993-1(b), 37 Fed. Reg. 20,853, 20,855 (1972).
55. *Id.*
56. *Id.*
57. I.R.C. § 993(c); Proposed Treas. Reg. § 1.993-3(a)(1), *as amended,* 41 Fed. Reg. 24,890 (1976).
58. I.R.C. § 993(c).
59. *Id.;* Proposed Treas. Reg. § 1.993-3(a)(3), *as amended,* 41 Fed. Reg. 24,890 (1976).

tion, or disposition outside the United States.[60] Finally, the property may not be sold to a DISC which is a member of the same controlled group.[61]

Revenues from leases of qualified export property are eligible for qualified export receipts treatment[62] if the DISC or its principal were owner or lessee of the property at the year the lease was to begin, and the DISC qualified for DISC treatment for the taxable year in which the lease began.[63] This inclusion acknowledges the similarity between many sales transactions and leases. Qualified export treatment should not be prevented because a particular transaction was termed a lease rather than a sale.

Related and subsidiary services[64] may be treated as qualified export receipts if they are customarily provided in similar transactions within the trade and relate to a sale or lease providing qualified export receipts.[65] Examples of such services are maintenance, repair, and warranty services.

Gross receipts from the sale, exchange, or other disposition of qualified export assets will also generate qualified export receipts.[66] Qualified export assets[67] refer to many of the assets customarily categorized as capital assets. Included, for example, are business assets,[68] defined as property used by the DISC to further the sale, lease, storage, handling, packing, or servicing of export property;[69] trade receivables held by the DISC or its parent,[70] if they are the result of a transaction that generated qualified export receipts; temporary investments, but only to the extent that they are necessary to maintain adequate working capital;[71] and short-term bank deposits, provided they are not held for over one year.[72]

An evidence of indebtedness known as a "producer's loan" also

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60. I.R.C. § 993(c)(1)(B).

61. *Id.* Section 993(a)(3) defines a "controlled group," adopting the section 1563(a) definition, as a chain of corporations, more than fifty percent of which are owned by a common parent, or more than fifty percent of which are owned and controlled by five or fewer individuals.

62. I.R.C. § 993(a)(1)(B).

63. Proposed Treas. Reg. § 1.993-1(c), 37 Fed. Reg. 20,853, 20,855 (1972).

64. I.R.C. § 993(a)(1)(C).

65. Proposed Treas. Reg. § 1.993-1(d), 37 Fed. Reg. 20,853, 20,855 (1972).

66. I.R.C. § 993(a)(1)(D).

67. *Id.* § 993(b).

68. Proposed Treas. Reg. § 1.993-2(a)(2), 37 Fed. Reg. 20,853, 20,858 (1972).

69. *Id.* § 1.993-2(c)(1), 37 Fed. Reg. 20,853, 20,858 (1972).

70. *Id.* § 1.993-2(a)(3), 37 Fed. Reg. 20,853, 20,858 (1972).

71. *Id.* § 1.993-2(e), 37 Fed. Reg. 20,853, 20,858 (1972).

72. *Id.*

qualifies as a qualified export asset.[73] Stocks and securities in related foreign export corporations can be qualified export assets.[74] Certain debt obligations of related foreign export corporations, if they are repaid in whole or in part during the taxable year of the DISC following that in which the obligation was acquired, will not be deemed to be qualified export assets unless the DISC can show that the obligation was repaid for a legitimate business purpose and not for the avoidance of federal income taxes.[75] Certain financing obligations will also be treated as qualified export assets if they are acquired by a DISC from an entity which is organized solely to finance sales of qualified export property pursuant to a guarantee contract with the Export-Import Bank of the United States.[76] The amount of Export-Import Bank-related loans is limited by the requirement that the sum of their bases added to the bases of outstanding producer's loans must not exceed the total accumulated DISC income.[77]

Dividends received by the DISC from a related foreign export corporation will also qualify. Three types of corporations are eligible. The first, a Foreign International Sales Corporation (FISC),[78] must be incorporated outside of a state or territory of the United States. The DISC must own fifty percent of the voting stock, and ninety-five percent of the corporation's income must be qualified export receipts. The second type of corporation whose dividends qualify is a real property holding company. The company must hold title to land only outside the United States and for the exclusive use of the DISC. Here also, the DISC must own over fifty percent of the voting stock.[79] The final type of related corporation, known as an associated foreign corporation, is a corporation in which the DISC owns as interest for the express purpose of maintaining a regular patronage. The ownership of the stock must have a reasonable relationship to the furtherance of transactions leading to qualified export receipts.[80] This test is satisfied if such ownership is necessary

73. See notes 94-102 *infra* and accompanying text.

74. I.R.C. § 993(b)(6).

75. Proposed Treas. Reg. § 1.993-2(g), 37 Fed. Reg. 20,853, 20,859 (1972).

76. I.R.C. § 993(b)(8).

77. Proposed Treas. Reg. § 1.993-2(h)(2), 37 Fed. Reg. 20,853, 20,859 (1972).

78. I.R.C. § 993(a)(1)(E). A Foreign International Sales Corporation (FISC) is a foreign selling arm of a DISC. The FISC is a foreign subsidiary, more than fifty percent of which is owned by the DISC and which meets qualification requirements similar to those imposed on a DISC, such as the ninety-five percent assets and receipts tests. *See id.* § 993(e)(1).

79. *Id.* § 993(e)(2).

80. *Id.* § 993(e)(3)(B).

to maintain the foreign corporation as a customer of the DISC or to aid in the sales distribution system of the DISC.[81] Here the DISC or its control group may not own over ten percent of the voting stock.[82]

C. *Excluded Property*

Transactions involving certain classes of property must be excluded from DISC treatment to ensure that goods not actually exported do not receive DISC treatment. In addition, certain policy considerations which override the policy behind the DISC enactment—that of increasing exports—necessitate exclusion of certain classes of property. Items specifically excluded from qualified export receipts treatment include receipts from the sale or lease of property ultimately for use in the United States.[83] In addition, any subsidized receipts are excluded.[84] Furnishing of architectural or engineering services to an instrumentality of the United States Government is excluded if furnished pursuant to a statute requiring such services to be provided by a United States national.[85] Here, even though the services may be performed outside the limits of the United States, they are, in a sense, not exported. Also, the controlling statute provides an adequate incentive for the company providing the services by requiring that they be performed by a United States national. Services for which the underlying sale does not qualify likewise will not qualify for qualified export receipts treatment.[86] Also, the managerial services allowance[87] does not include legal, accounting, scientific, or technical services.[88]

The overriding policy of conservation of scarce natural resources is behind the following exclusions added by the Tax Reform Act of 1976.[89] The 1976 Act revoked DISC benefits for the tax years beginning 1976 for the export of several types of depletable[90] natural resource products. Included are oil, gas, coal, uranium, and like

81. Proposed Treas. Reg. § 1.993-5(d)(3)(i), 37 Fed. Reg. 20,853, 20,866 (1972).
82. I.R.C. § 993(e)(3)(A).
83. *Id.* § 993(c)(1)(B).
84. Proposed Treas. Reg. § 1.993-1(j)(3), 37 Fed. Reg. 20,853, 20,857 (1972).
85. *Id.* § 1.993-1(j)(4), 37 Fed. Reg. 20,853, 20,857 (1972).
86. *Id.* § 1.993-1(j)(5), 37 Fed. Reg. 20,853, 20,857 (1972).
87. I.R.C. § 993(a)(1)(H).
88. Proposed Treas. Reg. § 1.993-1(i)(2), 37 Fed. Reg. 20,853, 20,856-57 (1972).
89. WAYS AND MEANS REPORT, *supra* note 6, at 265, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS at 3160.
90. *See* I.R.C. §§ 613, 613A.

products.[91] An exception to this change will be made for exports made before March 19, 1980, if they were made under a contract which was binding on the DISC or its control group on or before March 18, 1975. The contract must contain fixed price and quantity provisions;[92] hence, a contract to fulfill a purchaser's requirements or a contract with the price to be set at time of delivery will not qualify for this exception. DISCs electing this exception must adjust their base period deemed distribution according to the DISC income realized under this exception.[93] This basically transitional exception is designed so that the new law will not work a hardship on exporters of natural resources who set the terms of their contracts expecting to receive DISC benefits for the sales.

D. Producer's Loans

Producer's loans provide an incentive for persons electing DISC treatment to increase their investment in export-related assets at lower cost through the use of loans by the DISC of its previously untaxed income. The producer's loan is a device by which a DISC lends its tax-deferred profits back to its parent company or any other United States export manufacturing corporation. Producer's loans constitute qualified export assets, and interest received from producer's loans constitutes qualified export receipts.[94] The producer's loan must meet the following tests: (1) when added to the unpaid balance of all other producer's loans made by the DISC, the loan must not exceed the accumulated DISC income (tax-deferred profits) at the beginning of the month in which the loan is made; (2) the obligation must be evidenced by a note (or other evidence of indebtedness) with a stated maturity date which is not more than five years from the date of the loan; (3) the loan must be made to a person in the United States engaged in the manufacturing, production, growing, or extraction of export property; (4) at the time of the loan it must be designated as a "producer's loan."[95] There is no statutory requirement as to the interest to be charged on a producer's loan, but the section 482 requirement of a rate that clearly

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91. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1101(b), 90 Stat. 1658 (amending I.R.C. § 993(c)(2)).
92. *Id.*
93. See notes 117-34 *infra* and accompanying text for discussion of deemed distributions.
94. I.R.C. § 993(d).
95. *Id.* § 993(d)(1).

reflects income, such as the arm's length transaction method, is assumed applicable.[96]

The Tax Reform Act of 1976 has waived the requirement that a producer's loan be used for qualified export property in the case of loans to producers of certain property disqualified by the 1976 Act.[97] Thus, a DISC may still renew and make producer's loans to exporters of oil and gas, for example, and treat the loan as a qualified export asset even though the borrower will not be eligible for DISC benefits. The continued allowance of producer's loans to producers of disqualified property is one of the most troublesome provisions of the 1976 Act; it seems to run contrary to the Act's policy of keeping scarce natural resources in the United States. Unlike the binding contract exception, this is not a transitional measure and does not seem to alleviate an unexpected hardship. There is a basic contradiction between encouraging the conservation of scarce natural resources and, at the same time, providing tax incentives for their export abroad.

The Tax Reform Act of 1976 has not changed the limit on producer's loans to an individual borrower. Loans to a particular borrower are limited to the amount of the net assets of that borrower which are export related. This limit is computed using the unpaid balance of all outstanding producer's loans. The total number of outstanding producer's loans a borrower may have is limited to the sum of the bases of the borrower's plant and equipment, inventory, and research and development costs multiplied by the quotient of the borrower's export receipts arising from the sale of export property (through a DISC or otherwise), divided by the borrower's gross receipts from all inventory. Receipts for the three prior tax years are included, except that no year beginning before January 1, 1972 may be counted.[98] In addition, the DISC must show that the borrower increased its inventory, plant, machinery and equipment, and research and development expenditures in the United States by the amount of the loan. This "increased investment" requirement is designed to prevent the borrower's application of producer's loan proceeds to investments abroad.[99]

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96. Rothkopf, *DISC: Qualifying Under the New Export Income Laws: Advantages and Hazards,* 36 J. TAX. 130, 133 (1972).

97. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1101(c), 90 Stat. 1658 (amending I.R.C. § 993(d)(1)).

98. I.R.C. § 993(d)(2).

99. Hill & Replogle, Jr., *supra* note 34, at 392.

If a loan qualifies as a producer's loan at the time it is initially made, it will qualify at maturity. At maturity the old loan may be renewed if the DISC is still qualified for DISC treatment and if the renewal would not put it over the limit for producer's loans. A reduction of DISC income by distribution of losses will not disqualify a previously qualified loan; however, an increase in accumulated DISC income will not allow a previously unqualified loan to qualify.[100]

Although a producer's loan, by a DISC subsidiary to its parent, results in an interest deduction to the parent, the deduction is offset by the requirement that the interest received from a producer's loan is held to be deemed currently distributed to the DISC shareholders as a dividend.[101] The net effect of a producer's loan to a parent of a wholly-owned DISC is that the parent receives an interest-free loan if the interest is actually distributed as a dividend by the DISC. The reason for this is that the interest paid by the parent will completely offset the dividend, and the dividend income is not taxed to the DISC.[102]

V. INTERCOMPANY PRICING RULES

Because a DISC is usually wholly or partially owned by its suppliers, rules governing the price charged the DISC by its suppliers must be clearly delineated. If such rules were not clearly delineated, the opportunity for arbitrary manipulation of the incomes of both the parent and the DISC would exist. Transfer pricing rules between DISCs and related persons are established by section 994 of the Internal Revenue Code.[103] Section 994 allows the DISC to use the conventional arm's length transaction basis sanctioned under section 482.[104]

Section 994 allows two other methods, each of which would very likely have been set aside under section 482 as not reflective of arm's length transactions. Each of the two alternative methods may provide the DISC with a greater taxable income.[105] The first alternative

100. Proposed Treas. Reg. § 1.993-4(a)(2)(vi), 41 Fed. Reg. 24,889, 24,892 (1976).

101. I.R.C. § 995(b)(1)(E); Treas. Reg. § 1.995-2(a)(1) (1976).

102. Hill & Replogle, Jr., *supra* note 34, at 393.

103. I.R.C. § 994(a) adopts the section 482 definition of a related taxpayer. *See* Treas. Reg. § 1.482-1 (1968).

104. I.R.C. § 994(a)(3).

105. The House Ways and Means Committee favored this approach for two reasons: first, it would encourage the use of DISCs by allowing for potentially more deferred income; second, the complexities of section 482 pricing rules may be avoided. 1971 REPORT, *supra* note 10, at 65, *reprinted in* [1971] U.S. CODE CONG. & AD. NEWS at 1887.

allows the DISC a selling price yielding a profit equal to four percent of the qualified export receipts attributable to such sales plus ten percent of the related promotional expenses.[106] The second method allows the DISC fifty percent of the combined taxable income plus ten percent of the promotional expenses attributable to the qualified export receipts resulting from such sales.[107] Export promotion expenses are defined as those expenses, other than income taxes, which are incurred to advance the distribution or sale of export property, for use outside the United States.[108]

The tax deferral aspects of DISC income usually make it advisable to allocate as much income as possible to the DISC when the intercompany pricing rules allow.[109] The taxpayer who does not use the arm's length method must be careful not to allocate income to the DISC in a manner that causes the related supplier to sustain a loss.[110] If, however, the related supplier has been losing money from other operations, the transfer price may be higher so that revenues are generated for the supplier to offset against his losses.[111]

VI. TAXATION OF DISC SHAREHOLDERS

The basic mechanism of the DISC incentive, indeed the essence of the deferral scheme, is that the DISC entity itself is not subject to tax in the United States on any of its taxable income.[112] Therefore, the DISC entity will not pay any corporate income tax. The part of the income earned as a result of the DISC's operations that is taxed, is taxed to the DISC's shareholders. The shareholders are subject to a tax on the earnings and profits of the DISC as a dividend distribution, whether or not such earnings are in fact distributed to the shareholder.[113] The taxation scheme is very similar to that employed in the Subchapter S corporation incentive.[114] Two types of distributions are taxed to the shareholders: (1) actual distributions of money or property either for the normal dividend process, or to maintain DISC status,[115] and (2) deemed distributions of cur-

106. I.R.C. § 994(a)(1).
107. *Id.* § 994(a)(2).
108. *Id.* § 994(c).
109. Hill & Replogle, Jr., *supra* note 34, at 394.
110. Treas. Reg. § 1.994-1(e)(1) (1976).
111. *Id.*
112. *See* I.R.C. § 991.
113. *Id.* § 995(a).
114. *Id.* §§ 1371-1379.
115. *Id.* § 301; Treas. Reg. § 1.995-1(c) (1974). See notes 45-51 *supra* and accompanying text for discussion of deficiency distributions to maintain DISC status.

rent year's earnings and profits. Deferred earnings and profits are taxed upon disqualification for DISC status.[116]

A. Deemed Distributions

The DISC's income is taxed to the shareholders through the vehicle of deemed distributions. Each year the DISC will be deemed to have distributed fifty percent of its earnings for the current year on a pro rata basis to its shareholders; the deemed distributions are taxable to the shareholders.[117] Taxation on the remainder is deferred until it is actually distributed, the stock is disposed of, or the DISC is terminated. The taxable income for the DISC does not include income from producer's loans or income from the sale of assets for which the transferor of those assets to the DISC received nonrecognition treatment. These items are deemed fully distributed.[118]

The Tax Reform Act of 1976 limited tax deferral benefits for DISCs for taxable years beginning 1976 by a new category of deemed distributions.[119] An amount of the DISC's current income equal to sixty-seven percent of the average annual gross export receipts for a base period will be deemed distributed to the DISC's shareholders.[120] The base period for taxable years from 1976 to 1979 will be 1972 to 1975. Thereafter the base period will advance one year for each succeeding year.[121] The average of export gross receipts for the base period is the sum of the export receipts for the four-year period divided by four. Thus, if a DISC did not qualify for any one year of the base period, a zero will be summed in for that year's gross export receipts.[122]

The fifty percent deemed distribution of DISC taxable income will be calculated after the deduction of the base period deemed distribution.[123] The result will be a smaller amount of tax-deferred DISC income for most DISCs.[124] Small DISCs, with income less than

116. I.R.C. § 995(b).

117. *Id.* § 995(b)(1).

118. *Id.* §§ 995(b)-995(c).

119. C.C.H. TAX REFORM ACT OF 1976 ¶ 890 (1977).

120. I.R.C. § 995(b); Tax Reform Act of 1976, Pub. L. No. 94-455, § 1101(a)(4), 90 Stat. 1655-56 (adding I.R.C. § 995(e)).

121. After 1979 the base period will be the fifth, sixth, seventh, and eighth calendar years preceding the calendar year in which the current taxable year begins. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1101(a)(4) (adding I.R.C. § 995(e)(5)).

122. *Id.* § 1101(a)(4) (adding I.R.C. § 995(e)(6)).

123. *Id.* § 1101(a) (amending I.R.C. § 995(b)).

124. For example, *X* Corp., a DISC, has income for 1976 of $500,000 and an average annual base period income of $300,000. Its amount of tax deferred income, discounting provi-

$100,000 for the current year, will be waived from the average annual base period income deemed distribution.[125] Thus, these small DISCs will be no worse off in terms of deferred income than they were before the 1976 Act. This waiver is reduced by two dollars for every dollar of current income over $100,000 for the DISC.[126] The waiver is therefore completely eliminated for DISCs with current incomes of $150,000 or more.[127]

The sixty-seven percent average annual base period deemed distribution seems to represent a compromise between proponents of total deferral of export income, and those who would only have deferred increased export income. The Senate Committee concluded that the DISC legislation was made more inefficient by the allowance of deferral for all export income, rather than just increased export income.[128] A company would get DISC benefits whether or not its products would be sold overseas in the same quantity without tax incentives. Also, corporations decreasing their exports would get DISC benefits.[129] These were the main reasons for the addition of the sixty-seven percent base period deemed distribution. The Committee believed this provision would increase corporate efficiency, cut the cost of the DISC incentive in terms of lost federal tax revenues, and not hurt exports or the increased job opportunities resulting from the increased exports.[130]

There is, however, the possibility that Congress's strategy will backfire. It is impossible to say whether or not the base period deemed distribution, as structured by the Tax Reform Act of 1976, will actually act as a major stimulus toward increasing exports. In taxable years after 1979, the base period will consist of the sixth to

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sions of the 1976 Act, is $500,000 × 50% or $250,000. However, according to the 1976 Act, its deferred income is calculated as follows:

$500,000	taxable income
-200,000	base period deemed distribution
300,000	
-150,000	50% of taxable income deemed distributed
$150,000	total deferred tax DISC income

125. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1101(a), 90 Stat. 1657 (adding I.R.C. § 995(f)).

126. *Id.*

127. *Id.*

128. This was one of the criticisms of the original DISC legislation. See notes 20-23 *supra* and accompanying text.

129. *See* SENATE COMM. ON FINANCE, REPORT ON PUB. L. NO. 94-455, S. REP. NO. 94-938, 94th Cong., 2d Sess., pt. I, at 291-92, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3439, 3722 [hereinafter cited as FINANCE COMMITTEE REPORT, PART I].

130. *Id., reprinted in* [1976] U.S. CODE CONG. & AD. NEWS at 3722.

ninth preceding years. Several factors will contribute toward reducing the effect of this distribution on a DISC. First, only sixty-seven percent of the average annual base period export income is deemed distributed. This amount will be further diminished in real value by the inflation that will likely exist in the interval between the base period and the taxable year. In addition, many non-tax motivating factors, such as increasing sales, will likely cause corporations to try to increase exports despite the availability of DISC benefits. DISCs were intended to provide an added incentive to increase exports. The result could be that the base period deemed distribution may provide far less of an incentive to increase exports than Congress originally contemplated.

Increasing the base period deemed distribution may be conceptually more sound in terms of providing greater incentive to increase exports, but, as a practical matter, it might reduce benefits to such a point as to make the DISC plan unattractive.[131] This would be especially unattractive for the smaller DISCs which, as a result, are wholly or partially exempted from this provision.[132] This balancing of ideology and practicality may have been a chief ingredient in the compromise base period deemed distribution provision of the 1976 Act. Such a compromise was the only way to cut the huge loss of tax revenues from the DISC deferral[133] and, at the same time, to maintain some incentive to increase exports.

An additional deemed distribution will be required for taxable years beginning 1976, consisting of fifty percent of the taxable net income from sales of military property. Specific military property subject to this rule includes arms, ammunition, or implements of war designated in munitions lists.[134]

B. *Disqualification and Recapture*

DISC status may be lost either by voluntary election or by disqualification for failing to meet the requirements of DISC status

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131. For example, a corporation with $10,000,000 of qualified export receipts and a 10% profit margin could defer one-half of its profits, or $500,000, if there were no base period deemed distribution. If the same firm could defer only increased export income, then a 25% increase in exports over the base period level (a fairly average figure) would lead to a deferral of only $125,000 of income for $12,500,000 of exports ($2,500,000 additional qualified export receipts yielding a 10% or $250,000 profit, half of which is deferred). It would hardly be worth the trouble to comply with DISC requirements.

132. See note 6 *supra* and accompanying text.

133. See notes 129-30 *supra* and accompanying text.

134. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1101(a)(3), 90 Stat. 1655 (adding I.R.C. §§ 995(a)(1)(D) & (E), 995(b)(3), 995(e)(4)).

for five consecutive years.[135] In either case, all accumulated DISC income (tax-deferred earnings and profits) is deemed distributed pro rata to the shareholders.[136] These deemed distributions are treated as equal annual installments over a ten-year period following the disqualification or termination. If the DISC has been qualified for less than ten years, then the period of installments is equal to the period of qualification.[137] An actual distribution will be deemed to be in lieu of the final installments.[138] If the DISC subsequently requalifies, the deemed distribution installments nonetheless continue.[139] Since deemed distributions are not actually received by the shareholder, they will increase his basis in the DISC stock, rather than be viewed as taxable income.[140] When the deemed distributions are actually made, they are treated as a tax-free return of capital, and the basis of the DISC stock is reduced accordingly.[141]

Upon the disposition of DISC stock by the shareholder, by sale or redemption, taxable income will result. Not all of the taxable income will be capital gains; the shareholder will realize ordinary income as a dividend to the extent of the accumulated DISC income attributable to the shareholder's stock.[142] Here it is assumed that the selling price of the DISC stock takes into account the accumulated earnings and profits, some of which are attributed to tax-deferred DISC income. This is different from the treatment of a selling shareholder of an ordinary corporation who would get capital gains on the part of the price of the stock attributable to accumulated earnings and profits, despite the fact that the same earnings and profits would be ordinary income if distributed.[143] It should be noted, however, that the ordinary corporation is taxed both on the corporate and shareholder levels, whereas the DISC is taxed only on the shareholder level. Similar treatment of shareholder gain is required when stock is transferred in a nonrecognition transaction in which the DISC's corporate existence is terminated.[144]

The major change in disqualification and recapure of DISC income introduced by the 1976 Act is in the extension of the recap-

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135. I.R.C. § 992(b)(3).
136. *Id.* § 995(b)(2)(A).
137. *Id.* § 995(b)(2)(B).
138. Treas. Reg. § 1.995-3(e) (1976).
139. *Id.* § 1.995-3(d).
140. I.R.C. § 996(a)(1).
141. *Id.* § 996(e)(2).
142. *Id.* § 995(c).
143. *See Id.* § 301.
144. Treas. Reg. § 1.995-4(c) (1976).

ture period for the deferred income of a terminated DISC.[145] For taxable years beginning in 1976, a DISC that revokes its election or fails to qualify for DISC status may recapture its income over a period twice the length of time the DISC was in existence, rather than over a period equal to the length of the DISC's existence, as in the old rule. The maximum recapture time, however, is still ten years.[146]

This change will pave the way for many additional firms, which might not otherwise have done so, to experiment with the DISC method of exporting by providing greater tax savings for firms temporarily electing DISC benefits. The net savings for a firm electing DISC treatment and later revoking its election is the opportunity cost of borrowing funds equal to the tax deferral over the duration of the deferral.[147] By doubling the recapture time of the deferral income of a terminated DISC, the term of the "interest-free" loan of the tax on the deferred income is greater; the firm thus saves the cost of borrowing the amount of the tax deferral for the added time. Thus, under the 1976 Act, the DISC election provides a cheaper source of funds through tax deferral for a longer period than under the old law. There is greater incentive to increase exports through the use of DISCs by firms which, before the Tax Reform Act of 1976, would have derived negligible tax benefit from DISC election. The rule, requiring that any distribution on termination of DISC status in order to maintain the ninety-five percent qualified export receipts requirement, or otherwise to be made first out of deferred DISC income, has been changed for taxable years beginning 1976 to allow one-half of the distribution to be made first from untaxed earnings and the remainder from previously taxed earnings.[148] This will eliminate a possible double counting of DISC income.[149]

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145. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1101(a)(2), 90 Stat. 1655 (amending I.R.C. § 995(b)(2)(B)).

146. *Id.* Therefore, a DISC that has been in existence for four years will be able to recapture over an eight-year period rather than a four-year period, as under the old law. A DISC that has been in existence six years, however, may only spread its recapture over the ten year maximum.

147. The opportunity cost of a loan is the lowest interest rate at which the funds may be borrowed for the period of the loan. Any alternative loan must have a lower effective interest rate.

148. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1101(e), 90 Stat. 1659 (amending I.R.C. §§ 996(a)(1) & 996(a)(2)).

149. Once, as deferred income, and later, as a distribution.

VII. PARTICIPATION IN INTERNATIONAL BOYCOTTS

Congress has taken a bold new step in the integration of social policy and tax law by adding the boycott provisions to the Tax Reform Act of 1976.[150] The anti-boycott provisions of the 1976 Act extend to many other areas beyond the DISC provisions[151] and are an attempt to use the full force of the tax laws to discourage boycott participation. The Act provided that income received from, related to, or participating in an international boycott will be denied DISC benefits.[152] Section 1064 of the Tax Reform Act of 1976 adds section 999 of the Internal Revenue Code, regulating treatment of boycott-related activities.[153] Section 999(a) requires a boycott report to be filed by any person or member of a controlled group[154] with operations in or relating to any country (government, company, or national of that country) maintained on a boycott list by the Service.[155] Filing is also required for a person doing business in or with any country (government, company, or national of a country) if that person knows or has reason to know that participation in or cooperation with an international boycott is a condition for doing business in that country. The report shall include information as to whether the taxpayer had participated in, cooperated with, or was requested to participate in or cooperate with any such boycott.[156]

Any person or member of a controlled group which participates in a boycott in a taxable year at the request of a country will have all operations for the current year in that country deemed boycott related.[157] An exception to the above rule may be made if the tax-

150. Tax Reform Act of 1976, Pub. L. No. 94-455, §§ 1061-1064, 90 Stat. 1649-53 (adding I.R.C. §§ 908, 999; amending *id.* §§ 952(a), 995(b)(1)).

151. *Id.* Examples are the foreign tax credit, I.R.C. §§ 901-908; and Subpart F—Income of Controlled Foreign Corporations, I.R.C. §§ 951-964.

152. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1063, 90 Stat. 1650 (amending I.R.C. § 995(b)(1)).

153. I.R.C. § 999(b)(3) defines participating in a boycott as: agreeing as a condition of doing business in a country (either directly or indirectly) or with a government, company, or national of a country; to refrain from doing business with a specified country or nationals thereof which are the object of the boycott; to refrain from doing business with any United States citizen because that citizen does business with the boycott country; to refrain from doing business with a company whose owners are members of a particular nationality, race, or religion; or to refrain from employing such individuals.

154. See note 61 *supra* for definition of a controlled group.

155. I.R.C. § 999(a)(3) provides that the Secretary shall publish quarterly a list of all countries which require participation in a boycott as a condition of doing business in those countries.

156. *Id.* § 999(a)(2).

157. *Id.* § 999(b)(1).

payer can show that he did not participate in or cooperate with an international boycott despite such a requirement by the country in which he is doing business.[158] Also, the taxpayer may be exempted from boycott penalties on operations which can be shown to be "clearly separate and identifiable" from operations that are boycott related.[159] The taxpayer must clearly demonstrate that he did not participate.[160]

The denial of DISC benefits to participants in foreign boycotts is part of a larger reaction to certain illegalities, such as foreign bribes, in the conduct of overseas business by American corporations. The official rationale is given in the Senate Committee Report:

> The committee is concerned that U.S. business has been prevented from freely operating in international markets by the threat of economic sanctions by certain foreign countries or their employees. Unless the U.S. business agrees to cooperate or participate with certain foreign countries in an international boycott based upon nationality or religion, they are denied the opportunity to conduct business with a country. It is particularly unfair in the committee's belief, when the taxpayer who participates in the boycott is a recipient of tax preferences by reason of the participation. The committee believes that many taxpayers would not participate in an international boycott if the taxpayer and the foreign countries were made aware that tax preferences were not available to a taxpayer who participates in such a boycott.[161]

The above statement only hints at the real reasons for this provision. Congress has responded to public concern over the attempt by many oil-producing Arab nations to use their oil wealth as a weapon against Israel in a manner that violates the rights of American citizens. Senator Ribicoff, in his speech supporting the anti-boycott legislation, emphasized the systematic nature of the boycott and estimated that as many as 3,000 companies were boycotting 2,000 other firms that either do business with Israel or were controlled by Jews.[162]

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158. *Id.*

159. *Id.*

160. *Id.* § 999(b)(2).

161. FINANCE COMMITTEE REPORT, PART I, *supra* note 129, *reprinted in* U.S. CODE CONG. & AD. NEWS at 3718.

162. 122 CONG. REC. S3377 (daily ed. March 15, 1976) (remarks of Sen. Ribicoff, introducing S. 3138—A bill to amend the Internal Revenue Code of 1954 to deny certain benefits to taxpayers who participate in or cooperate with the boycott of Israel). S. 3138, 94th Cong.,

A troublesome dilemma exists as to whether the correction of moral injustice is an appropriate use of the tax laws which ideally should be used for the sole purpose of raising revenue. While there is some merit to the contention that the tax laws should not be affected by international politics, the boycott issue transcends politics alone. American corporations have been induced into illegally discriminating against certain classes of individuals,[163] even in domestic operations, by promises of larger purchases or investments of petrodollars.[164] Congress has taken the minimum first step of denying the aid of the tax laws to patently illegal acts.

VIII. IMPROVEMENTS IN THE BALANCE OF PAYMENTS POSITION

The original DISC legislation improved the balance of payments position in several ways. It negated many of the competitive advantages which other countries' exporters enjoyed through retention of export profits in subsidiaries in tax haven countries.[165] United States exporters could pass along the tax savings to their customers, thereby further improving the U.S. trade position.

In 1971, when the DISC legislation was enacted, the balance of payments deficit was of record proportions.[166] In 1972, after the DISC legislation became effective, a marked decrease in the deficit in the balance of payments was registered. It was still, however, much higher than in past years.[167]

In 1973, there was a complete turnabout in the United States foreign trade position. That year saw the first balance of payments surplus since 1957.[168] Exports increased forty-four percent over 1972,

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2d Sess. (1976), as modified, eventually became the anti-boycott provisions of the Tax Reform Act of 1976. See note 150 *supra* and accompanying text. Examples of boycotted firms include: Ford Motor Co., National Broadcasting Co., Sears, Roebuck & Co., Allstate Insurance Co., Republic Steel Co., Xerox Corp., Zenith Radio Corp. Schwartz, *The Arab Boycott and American Responses: Antitrust Law or Executive Discretion,* 54 TEX. L. REV. 1260, 1265 (1976).

163. The original text of the bill referred to the "boycott of Israel," and Senator Ribicoff, in his speech introducing the bill, linked the boycott to discrimination against Jews in domestic operations of American firms, 122 CONG. REC. at S3377-78.

164. *Id.*

165. Considine, *The DISC Legislation: An Evaluation,* 7 N.Y.U. J. INT'L L. & POL. 217, 219 (1974).

166. Using the liquidity method, the balance of payments deficit was $22.1 billion in 1971, $9.819 billion in 1970, and $6.985 billion in 1969. BALANCE OF PAYMENTS REP. (CCH) ¶¶ 195, 193, 192 (1972).

167. The deficit in 1972 was $14.06 billion. *Id.* ¶ 199 (1974).

168. The 1973 surplus was $1.4 billion by the current accounts method. *Id.* ¶ 200 (1974). There was $7.8 billion deficit by the liquidity method. *Id.* ¶ 9178 (1974).

showing a surplus of $0.7 billion, as opposed to a deficit of nearly $7 billion in 1972.[169] Although there is little or no hard data on exactly how much of this turnaround is attributable to the DISC legislation, the House Ways and Means Committee concluded that a substantial amount must be attributed to the DISC incentive.[170] The large increase in exports in 1973 can probably be attributed, at least in part, to the fact that 1973 was likely the first year in which the full effects of the DISC legislation were felt.[171] While other factors, such as a 17.3% devaluation of the dollar over a year-long period ending February 1973[172] also contributed to the increase in exports, the DISC legislation's impact cannot be ruled out.

The use of DISCs by exporters has continued to increase,[173] to the benefit of the United States trade position.[174] Although the quadrupling of oil prices helped produce a trade deficit in 1974,[175] a large surplus was registered in 1975 despite high oil prices and increased oil imports.[176] In 1976, exports increased by four percent. However, due to stockpiling of oil in anticipation of an oil price increase by the Organization of Petroleum Exporting Countries (OPEC), a net deficit in the balance of payments resulted.[177]

It is impossible to predict what effect the changes in the DISC provisions of the Tax Reform Act of 1976 will have on the balance of payments position. The House Ways and Means Committee believed that the added pressure to increase exports provided by the 1976 Act would counteract the effect of the Act's reduction of benefits of the DISC incentive. The Committee believed that the incentive to increase exports would be maintained,[178] although questions remain.[179]

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169. *Id.* ¶ 200 (1974).

170. *See* WAYS AND MEANS REPORT, *supra* note 6, at 263-73, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS at 3158-69.

171. There were about 2,000 DISCs in operation at the end of 1972. Comment, *GATT, Altered Economics, and DISC: A Legitimate Application of Rebus Sic Stantibus*, 5 DEN. J. INT'L L. & POL'Y 121, 126 (1975) [hereinafter cited as *Altered Economics*].

172. Considine, *supra* note 165, at 221.

173. By June 1974, there were over 5,000 DISCs. *Altered Economics, supra* note 171, at 126.

174. *See* WAYS AND MEANS REPORT, *supra* note 6, at 263, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS at 3159.

175. $10 billion, by the current accounts method. BALANCE OF PAYMENTS REP. (CCH) ¶ 9199 (1975).

176. A $9.0 billion trade surplus existed ($1.46 billion by current accounts). *Id.* ¶ 9232 (1976).

177. The net deficit was $9.6 billion. *Id.* ¶ 9263 (1977).

178. WAYS AND MEANS REPORT, *supra* note 6, at 264, *reprinted in* U.S. CODE CONG. & AD. NEWS at 3159-60.

179. See notes 131-33 *supra* and accompanying text for discussion of questions.

IX. CONCLUSION

The Tax Reform Act of 1976 responded to many of the long-standing criticisms of the DISC shelter, which had been present since the DISC scheme was first enacted.[180] The base period deemed distribution helped to reduce the cost of the DISC incentive in terms of lost tax revenues, thus responding to the major criticism. It remains to be seen, however, whether this change will provide added incentive to increase exports through DISCs, or decrease the use of DISCs, with a resulting decreasing incentive to increase exports, because of the smaller tax advantage. Products needed at home are now being denied DISC benefits, as is boycott-related income. The result will be that the tax incentive will be provided only where its use will benefit United States interests.

On the whole, Congress believed that the DISC legislation was successful in improving the balance of payments, and in increasing exports.[181] The Senate Committee directly attributed much of the increase in United States exports from 1971 to 1975 to the DISC legislation.[182] The result has been a streamlined DISC incentive that will very likely play a greater role in shaping United States exports in the coming years.

Alan Laufer

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180. See notes 20-23 *supra* and accompanying text for discussion of criticisms.

181. FINANCE COMMITTEE REPORT, PART I, *supra* note 129, at 291-92, *reprinted in* U.S. CODE CONG. & AD. NEWS at 3722.

182. Exports increased from $43 billion in 1971 to $107 billion in 1975. *Id.*