Winner of the 1977 Rusk Award in International Law*

FINE-TUNING THE DISC: EVALUATION AND FRAMEWORK**

I. INTRODUCTION

Concerned about an increasing balance of trade deficit, advantageous tax treatment of United States corporations manufacturing abroad through foreign subsidiaries, and actions taken by other countries to stimulate their export trading, Congress in 1971[1] initiated a tax incentive export program for domestic businesses with the express intent of increasing U.S. export activity.[2] This program which introduced a new type of corporation—the Domestic International Sales Corporation (DISC)—allows a domestic corporation to form a DISC as a "dummy" subsidiary corporation for use as a conduit for all of its export transactions. Substantially all of the gross receipts of a qualifying DISC are derived from, and substantially all of its assets related to, export activities, with export income receiving special tax treatment. No income tax is levied upon the DISC itself, and DISC shareholders (usually a parent corporation) are taxed only when DISC income is distributed to them. Each year the DISC is deemed to have distributed a certain portion of its income, whether it has done so or not; this income, therefore, is currently taxable to the shareholders. The balance of the income remains in a tax-deferred status until one of three events occurs: the income is actually distributed; the DISC shareholder sells his stock; or the corporation loses its DISC qualification. Additional provisions of the tax program enable DISC shareholders to obtain the use of this tax-deferred income prior to distribution. Thus, the plan allows a DISC to defer for an indefinite period taxation of a certain portion of its export-derived income, while allowing the shareholders of the DISC to obtain current use of that income.

The response of the American business community to DISC has been impressive. By March of 1972, only three months after the creation of the DISC program, 1,136 DISCs had been formed.[3] By February of 1976, this number had grown to 8,382.[4] Further, the percentage of U.S. exports channeled through DISCs grew from 40.3 percent in 1972[5] to an estimated 75 percent in 1976.[6] During the same period exports climbed dramatically. In

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[1] Revenue Act of 1971, Pub. L. No. 92-178, § 501, 85 Stat. 497 (1971).

[2] H.R. REP. No. 92-533, 92d Cong., 1st Sess. 1, *reprinted in* [1971] U.S. CODE CONG. & AD. NEWS 1825, 1831.

[3] DEPARTMENT OF THE TREASURY, THIRD ANNUAL REPORT ON THE OPERATION AND EFFECT OF THE DOMESTIC INTERNATIONAL SALES CORPORATION LEGISLATION 27 (1976) [hereinafter cited as THIRD ANNUAL TREASURY REPORT].

[4] *Id.*

[5] *Id.* at 35.

[6] GENERAL AGREEMENT ON TARIFFS AND TRADE, REPORT OF THE PANEL, UNITED STATES TAX LEGISLATION (DISC) 4 (1976) [hereinafter cited as GATT REPORT].

1971 U.S. exports totalled $43.5 billion[7] while 1976 exports reached $114.1 billion,[8] an increase of over $70 billion in the five year span.

Despite the strong response to DISC and the significant increase in U.S. export activity, the DISC program has been the target of intense opposition. Domestic critics maintain that the DISC program is a costly, ineffective export incentive which serves only as a tax haven for large U.S. exporting corporations while providing no substantial stimulus to U.S. export activity.[9] These critics attribute the bulk of U.S. export growth over the past five years to factors other than DISC (such as devaluation of the dollar, institution of floating currency exchange rates, and increased foreign demand for U.S. goods), and argue that DISC has accounted for less than one percent of the total increase in U.S. exports.[10]

Our foreign trade competitors criticize the DISC program for different reasons. The European Economic Community in 1973 lodged a formal complaint with the General Agreement on Tariffs and Trade (GATT)[11] alleging that the DISC program was incompatible with GATT[12] because it constituted a direct tax subsidy on exports.[13] In 1976, after an examination of DISC, a GATT panel found that DISC had effects which were not in accordance with U.S. obligations under GATT.[14]

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[7] COUNCIL ON INTERNATIONAL ECONOMIC POLICY, THIRD ANNUAL INTERNATIONAL REPORT 133 (1975).

[8] U.S. DEP'T OF COMMERCE, SURVEY OF CURRENT BUSINESS 7 (Jan. 1977).

[9] H.R. REP. No. 92-533, *supra* note 2, at 108 (dissenting views of Hon. Sam Gibbons).

[10] STAFF OF HOUSE COMM. ON THE BUDGET, 94TH. CONG., 1ST SESS., AN ANALYSIS OF DOMESTIC INTERNATIONAL SALES CORPORATIONS (DISC) 6 (Comm. Print 1975) [hereinafter cited as 1975 HOUSE REPORT].

[11] General Agreement on Tariffs and Trade, 55 U.N.T.S. 194 (1947), *reprinted in* 61 Stat. pt. 5, at A3 (1947) [hereinafter cited as GATT]. The acronym GATT as generally used refers both to the organization of signatories to the General Agreement and to the General Agreement itself. GATT was negotiated in Geneva in 1947 and has since become the principle instrument for regulation of world trade. It is interesting to note that the Senate has never given advice and consent to the General Agreement. United States participation is based solely on executive agreement. *See* Jackson, *The General Agreement on Tariffs and Trade in U.S. Domestic Law*, 66 MICH. L. REV. 249 (1967).

[12] GATT, *supra* note 11, art. XVI. This article requires any party to GATT granting an export subsidy to notify GATT in writing the nature and extent of the subsidization and of the circumstances which make the subsidization necessary. If it is determined that a serious prejudice to the interests of another party to GATT is caused by the subsidization, the party granting the subsidy shall, upon request, discuss the possibility of limiting the subsidization. *See* Comment, *The DISC Legislation as a Violation of the General Agreement on Tariffs and Trade*, 41 MO. L. REV. 180 (1976).

[13] THIRD ANNUAL TREASURY REPORT, *supra* note 3, at 6. For a detailed discussion of the relationship of DISC to our obligations under GATT, see Anninger, *DISC and GATT: International Trade Aspects of Bringing Deferral Home*, 13 HARV. INT'L L.J. 391 (1972).

[14] GATT REPORT, *supra* note 6, at 16. GATT as a body has no power to impose any sanctions to enforce compliance with its findings. Only the other parties to GATT may take retaliatory action. *See* GATT, *supra* note 11, arts. XVI (4), XIX, XXIII. GATT may, however, under extreme circumstances decide that a GATT member is free to leave the organization. *Id.* art. XXIII.

Thus the DISC program is criticized on seemingly contradictory grounds. Domestic critics charge that DISC is an ineffective export trade stimulus, while foreign critics view DISC as an improper tax subsidy creating an unfair advantage for U.S. exporters. GATT's ruling was based in part on a finding that DISC did lead to an increase in exports,[15] but if DISC is, as its domestic critics argue, a generally ineffective export incentive, then GATT's criticism seems somewhat alarmist. An export program which violates GATT in form should not greatly disturb our foreign competitors if that program is in fact largely ineffective.[16] On the other hand, if GATT's assessment is accurate, and DISC does function as an effective tax subsidy for exports, then it seems that the domestic critics are in error when they contend that DISC has played only a minimal role in the expansion of U.S. export activity.

These two incompatible criticisms of DISC illustrate a problem that has plagued the program since its inception—the need for an accurate determination of the actual impact of DISC on U.S. export activity. The question remains whether DISC is in fact an effective tax incentive for stimulating exports or is instead merely a windfall to exporters. By applying a cost-benefit analysis to the DISC program, the principal cost of DISC in terms of lost revenue is fairly clear.[17] This cost figure, which far exceeds the initial DISC program estimates, will reach a projected $1.58 billion in fiscal year 1977.[18] However, the determination of DISC benefits, *i.e.*, the increase in U.S. exports attributable solely to DISC, has proven a highly difficult task due to the extreme complexity of the various forces which bear on U.S. international trade. Different studies abound, but they offer sharply con-

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[15] GATT REPORT, *supra* note 6, at 16.

[16] Indeed, some of the countries which complained about DISC have tax incentive programs themselves which are designed to stimulate exports. In response to the complaint against DISC by the European Economic Community, the United States entered a counter-complaint against the export practices of Belgium, France, and the Netherlands. *See* THIRD ANNUAL TREASURY REPORT, *supra* note 3, at 6. The same members of the GATT panel which found DISC not to be in accordance with U.S. obligations under GATT on the same day found that the complained-of tax practices of Belgium, France and the Netherlands likewise were not in accordance with obligations under GATT. *See* GENERAL AGREEMENT ON TARIFFS AND TRADE, REPORT OF THE PANEL, INCOME TAX PRACTICES MAINTAINED BY BELGIUM 10 (1976); GENERAL AGREEMENT ON TARIFFS AND TRADE, REPORT OF THE PANEL, INCOME TAX PRACTICES MAINTAINED BY FRANCE 12 (1976); GENERAL AGREEMENT ON TARIFFS AND TRADE, REPORT OF THE PANEL, INCOME TAX PRACTICES MAINTAINED BY THE NETHERLANDS 10 (1976). Unless these countries viewed DISC as a substantial factor in stimulating exports, it seems they would not have raised the issue of DISC with GATT, since it was clearly foreseeable that the United States would launch a counter-complaint against their own tax practices.

[17] THIRD ANNUAL TREASURY REPORT, *supra* note 3, at 23. The revenue cost of DISC arises from the deferral of tax on a portion of DISC income. The Treasury estimates of DISC revenue cost assume that total exports would have been at the same level even in the absence of DISC. Also, the Treasury takes no account of the fact that, in the absence of DISC, companies might find other ways to "shelter" some of their export profits from current taxation.

[18] *Id.*

flicting conclusions as to DISC's effectiveness as an export stimulus.

This continuing concern over DISC's effectiveness resulted in the changes in DISC's structure embodied in the 1976 Tax Reform Act.[19] That Act significantly altered the DISC income distribution plan, its stated congressional goal being to make DISC "more efficient and less costly while still providing incentives for increased exports."[20] This retention of the DISC program in modified form indicates that Congress accepted the conclusion that DISC was responsible for a "significant portion of the increase in exports which has taken place"[21] in the United States. DISC critics, however, have not been silenced by the 1976 changes. Domestic critics still view DISC as an inherently ineffective export stimulus.[22] Therefore, even though DISC's cost in terms of foregone revenue has been lowered by the 1976 amendments,[23] these critics still believe that the cost far outweighs the program's benefits. In addition, GATT and other foreign critics of DISC are no doubt displeased with the 1976 changes in DISC's structure, for if the 1976 DISC amendments accomplish their stated purpose of providing effective incentives for increased exports, the problems raised by DISC in the international context will be exacerbated.

This Note will examine the DISC program from several interrelated perspectives. A brief sketch of the DISC operational structure will be presented, followed by a discussion of some of the major studies of DISC's effectiveness as an export trade incentive. The assumptions, methods of analysis, and conclusions of these studies will be discussed and contrasted. The discussion will then focus upon the 1976 DISC amendments which emerged from congressional debates over the relative merits of the studies. Particular attention will be paid to the modifications of the DISC income distribution scheme. Finally, in view of the continuing controversy over DISC, this Note will propose an analytical framework within which it is suggested that any further action on DISC should be discussed and evalu-

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[19] Tax Reform Act of 1976, Pub. L. No. 94-455, § 1101, 90 Stat. 1520 (1976) [hereinafter cited as 1976 DISC amendments].

[20] H.R. REP. No. 94-658, 94th Cong., 2d Sess. 264, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 2897, 3159 [hereinafter cited as 1976 HOUSE DISC PROPOSAL].

[21] *Id.*

[22] Wall St. J., Jan. 5, 1977, at 1, col. 6.

[23] The House version of the 1976 DISC amendments would have increased estimated tax liabilities by approximately $500 million per year for the five year period from 1976 through 1980. *See* 1976 HOUSE DISC PROPOSAL, *supra* note 20, at 2916.

The Senate version of the 1976 amendments would have increased estimated tax liabilities by approximately $84 million in 1977, $306 million in 1978, and over $400 million each year for the next three years. *See* S. REP. No. 94-983, 94th Cong., 2d Sess. 26, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3439, 3462.

The DISC amendments finally adopted were forecast by the Conference Committee to increase revenues by $468 million in 1977 and further increase revenues each year thereafter, resulting in an additional $728 million in tax revenue by 1981. *See* CONF. REP. No. 94-1515, 94th Cong., 2d Sess. 626, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 4264.

ated. It is hoped that this framework will provide a logical approach to the complex and subtle issues which surround this controversial export program.

II. THE DISC STATUTORY FRAMEWORK

To qualify as a DISC under the Internal Revenue Code,[24] a corporation must meet four initial criteria:[25]

> (1) ninety-five percent or more of the gross receipts of the DISC must consist of qualified export receipts (QERs),[26] which have been defined to include primarily gross receipts from the sale, exchange, or lease of export property.[27] Export property, in turn, consists mainly of property manufactured, produced, grown, or extracted in this country for consumption or disposition outside the U.S.[28]
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> (2) ninety-five percent or more of all corporate assets must be qualified export assets (QEAs),[29] which includes any export property, accounts receivable arising from DISC transactions, and DISC capital.[30]
>
> (3) The corporation must have only one class of stock, and the par or stated value of its outstanding shares must be worth at least $2,500 on each day of the year.[31]
>
> (4) The corporation must elect to be treated as a DISC.[32]

As these criteria indicate, in order for a corporation to receive DISC benefits, substantially all of its transactions and assets must be export related. The small amount of capitalization needed and the simple organizational requirements, however, make it clear that the DISC can function effectively as a "paper" corporation serving primarily as a conduit for the export transactions of the DISC's parent.[33]

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[24] The basic statutory and regulatory provisions dealing with DISC structure and operation are found in I.R.C. §§ 991-97 (1971), *as amended by* the Tax Reform Act of 1976, Pub. L. No. 94-455, § 1101, 90 Stat. 1520 (1976) and Treas. Reg. §§ 1.991-1 to 1.997-1 (1975), respectively. *See also* Note, *A Tax Analysis of Domestic International Sales Corporations (DISC): The Case of the Slipped Disc?*, 6 CALIF. W. INT'L L.J. 154 (1975); Comment, *DISC: A Tax Primer*, 20 LOY. L. REV. 325 (1974).

[25] I.R.C. § 992. The Treasury has added some additional bookkeeping requirements. *See* Treas. Reg. § 1.992-1(a) (1975). For a discussion of DISC formation, see Feinschreiber and Granwelb, *Forming a DISC under Proposed Regulations*, 29 BUS. LAW. 149 (1973).

[26] I.R.C. § 992(a)(1)(A). *See generally* Note, *DISC: Qualified Export Receipts under the Proposed Regulations*, 10 WILLAMETTE L.J. 243 (1974).

[27] I.R.C. § 993(a)(1)(A).

[28] *Id.* § 993(c)(1).

[29] *Id.* § 992(a)(1)(B).

[30] *Id.* § 993(b).

[31] *Id.* § 992(a)(1)(C).

[32] *Id.* § 992(a)(1)(D).

[33] While it is possible to have an independent DISC, over 80% are owned by a majority

One of the most important features of the DISC program is its system of intercompany pricing rules which allocates between the DISC and its parent the total income derived from export activities.[34] These rules, which have been described as the "heart" of the DISC program,[35] allow the DISC and its parent to maximize the amount of income on which tax may be deferred by choosing from among three available methods of pricing the one which results in the greatest allocation of income to the DISC.[36] In addition, under certain conditions a marginal cost-accounting procedure may be used which allows the parent to allocate production costs of certain products or product lines between its export sales through DISC and its domestic sales of the same item.[37] As a result corporations may be able to allocate a larger portion of their costs to domestic production than would be allowed under normal accounting methods. Use of this procedure increases the income derived from export transactions by reducing export costs, and consequently enlarges the amount of income available for tax

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corporate shareholder. THIRD ANNUAL TREASURY REPORT, *supra* note 3, at 24. This Note utilizes the term "parent" in referring to the party with whom the DISC transacts its export business, but does not suggest that the DISC should necessarily be owned only by a parent corporation.

[34] I.R.C. § 994. *See generally* Carey, *DISC Intercompany Pricing Rules: Section 994 of the Proposed Regulations*, 19 LOY. L. REV. 579 (1973).

[35] *DISC*, 26 TAX LAW. 537, 540 (1973) (a panel discussion sponsored by the Section on Taxation of the American Bar Association).

[36] The three available methods are: (1) allocation of 4% of the QERs of the DISC plus 10% of export promotion expenses. Thus a DISC with $1,000,000 of QERs could allocate to itself $40,000 of the combined export-derived income of the DISC and the parent plus 10% of export promotion expenses. I.R.C. § 994(c) defines export promotion expenses to include expenses to advance the distribution or sale of export property outside the United States and 50% of freight expenses where the DISC voluntarily ships its products aboard United States ships and aircrafts; (2) allocation of 50% of the combined taxable income of the DISC and its parent which is attributable to QERs plus 10% of export promotion expenses as defined above. Thus, if the combined taxable income of the DISC and its parent were $200,000, the DISC could allocate $100,000 to itself plus 10% of the export promotion expenses; (3) allocation based upon the sales price actually changed, subject to I.R.C. § 482, which gives the Secretary of the Treasury authority to reallocate income distribution when necessary to clearly reflect the income of such corporation. I.R.C. § 994(a). *See generally* Note, *Domestic International Sales Corporations--A Tax Incentive for Exporters*, 56 MINN. L. REV. 407, 443 (1972).

The choice of pricing method will generally depend upon the ratio of the combined export-derived income of the DISC and its parent to the total sales receipts of the DISC. If this ratio (in essence the profit margin) is less than 8%, it generally is advantageous to use the 4% of QER income allocation method. If the profit margin is greater than 8%, the 50% method of income allocation generally is more advantageous. As most corporations have higher profit margins on their export transactions, the 50% method of allocation is most widely used. *See* THIRD ANNUAL TREASURY REPORT, *supra* note 3, at 8.

[37] *See* Treas. Reg. § 1.994-2. Generally, if a DISC is seeking to establish or maintain a foreign market for sales of an item, the marginal costing rules are applicable. Marginal costing rules may be used only in conjunction with the 50% method of income allocation. For an in-depth discussion of marginal costing, see Kauder, *Marginal Costing for DISCs: An Explanation and Analysis of Treasury's Proposed Regs*, 38 J. OF TAX. 304 (1973).

deferral. Thus, through use of advantageous pricing and cost allocation rules, the exporter is able to assign a large portion of its export-related income to the DISC and thereby defer the payment of tax on a portion of that income.

Prior to the 1976 DISC amendments, the DISC taxation provisions "deemed" approximately one-half of a DISC's total income distributed to the shareholders. This deemed distribution, whether distributed in fact or not, was currently taxable to the shareholder, but the DISC was allowed to defer taxation on the undistributed balance.[38] This tax-deferred income could then be made available to the DISC's parent by one of two principal methods. The DISC could either lend the money to its parent under the terms of a "producer's loan"[39] or purchase the parent's accounts receivable generated by export transactions through the DISC.[40] Because the terms of a producer's loan are subject to certain restrictions,[41] the accounts receivable method is the preferred method of transmitting tax-deferred income to the parent for present use without subjecting that income to current taxation.[42]

Tax deferral continues as long as the DISC remains qualified under the Internal Revenue Code provisions. If a DISC becomes disqualified the tax-deferred income is recaptured through a number of yearly distributions.[43]

The 1971 DISC provisions allowed an exporter to create a "paper" DISC corporation through which to channel its exports, facilitating allocation of a substantial portion of the exporter's export-related income to the DISC. The DISC could then defer taxation of approximately one-half of its income, and the parent could reach and use that income without subjecting it to immediate taxation. Under these original provisions all DISCs were treated in the same manner regardless of parent size or level of income, and there was no requirement that a DISC increase its export activity in

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[38] I.R.C. § 995 (1971), *as amended by* the 1976 DISC Amendments, *supra* note 19.

[39] I.R.C. § 993(d). *See* Note, *Domestic International Sales Corporations: In Defense of Producer's Loans*, 8 CORNELL INT'L L.J. 108 (1974).

[40] I.R.C. § 993(b)(3).

[41] There are three basic limitations on a producer's loan: (1) the loan, when added to the unpaid balance of all other producer's loans, cannot exceed the accumulated DISC income at the beginning of the month the loan is made; (2) there must be a written indebtedness of not more than five years; and (3) the loan must be made to a person engaged in United States manufacturing, production, or extraction of export property. In addition, the loan must be designated as a producer's loan, and the interest received by the DISC is deemed distributed and is taxed in the hands of the stockholder. I.R.C. § 993(d), *as amended by* the 1976 DISC amendments, *supra* note 19.

[42] In 1974 71% of all DISC QEAs were accounts receivable, while only 4% of QEAs were producer's loans. THIRD ANNUAL TREASURY REPORT, *supra* note 3, at 9, 11.

[43] The original provision, I.R.C. § 995 (b)(2)(B), allowed a number of distributions equal to the number of years the DISC had been in existence, not to exceed 10 years. The 1976 DISC amendments changed the formula to twice the number of years the DISC had been in existence, still, however, not to exceed 10 years.

order to continue to enjoy the tax deferral benefits. Any DISC could therefore defer approximately one-half of its taxable income each year, even if its level of export activity remained stable or decreased over the years.

III. DISC'S EFFECTIVENESS AS AN EXPORT STIMULUS

Once in operation, the DISC program was praised by some as a significant factor in stimulating U.S. export activity and criticized by others as a costly and ineffective tax incentive; numerous studies of the program were made, reaching widely varying conclusions on DISC's effectiveness. However, it has been virtually impossible to make an accurate evaluation of DICS's impact on U.S. export trade because of the numerous other forces affecting U.S. export activity during the study years.[44] For example, between 1972 and 1975 the dollar was devalued twice,[45] an international flexible currency exchange system was instituted,[46] demand abroad for American goods (especially agricultural products) increased,[47] and a price control system instituted in the United States encouraged sales abroad where domestic price ceilings did not apply.[48] Nevertheless, several studies sought to isolate and quantify the DISC impact on U.S. export activity. Three of those studies, the relative merits of which were vigorously debated in Congress prior to passage of the Tax Reform Act of 1976,[49] will be examined in this section as a prelude to a discussion of the 1976 DISC amendments.

A. *House Budget Committee Report*

The House of Representatives Committee on the Budget Report[50] estimated that DISC accounted for less than one percent of the increase in U.S. exports from 1971 through 1975.[51] The Committee reached this conclusion by employing a price elasticity of demand analysis,[52] which con-

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[44] *See* THIRD ANNUAL TREASURY REPORT, *supra* note 3, at 1; TASK FORCE ON TAX POLICY AND TAX EXPENDITURES, SENATE COMM. ON THE BUDGET, 94TH CONG., 1ST SESS., SEMINAR—DISC: AN EVALUATION OF THE COST AND BENEFITS (Comm. Print 1975) [hereinafter cited as SENATE DISC SEMINAR].

[45] THIRD ANNUAL TREASURY REPORT, *supra* note 3, at 1. One devaluation took place in December 1971, just prior to creation of the DISC program, but the effects were clearly felt during the period of DISC's existence. The second devaluation occurred in February 1973.

[46] COUNCIL ON INTERNATIONAL ECONOMIC POLICY, 2D INTERNATIONAL ECONOMIC REPORT 9 (1974). The floating or flexible exchange system was instituted in March 1973.

[47] THIRD ANNUAL TREASURY REPORT, *supra* note 3, at 1.

[48] Cost of Living Council Economic Stabilization, 6 C.F.R. § 101.34(d) (1973).

[49] *See, e.g., Domestic International Sales Corporations (DISC): Hearings on Tax Reform Before the House Comm. on Ways and Means*, 94th Cong., 1st Sess. 2245-2351 (1975) [hereinafter cited as *Hearings on Tax Reform*].

[50] 1975 HOUSE REPORT, *supra* note 10.

[51] *Id.* at 6.

[52] For an in-depth development of the price elasticity of demand analysis as applied to DISC, see Considine, *The DISC Legislation: An Evaluation*, 7 N.Y.U. J. INT'L L. & POL. 217 (1974).

verts a given percentage drop in the price of an item into an estimated percentage increase in sales volume and net sales receipts of that item. It was estimated that the DISC provisions would enable an exporter to reduce the prices of his exported goods by an estimated maximum of 1.8%. Using an export price elasticity of demand of 1.51,[53] and assuming that the entire price reduction was passed on to the foreign customer and not retained as increased profit, a 1.8% drop would increase sales volume by 2.7% (1.8% x 1.51). Not all of this increase in sales volume, however, results in higher sales revenue, since the price per item is now lower.[54] Applying a net sales receipt elasticity of .49%, a 1.8% price reduction would increase net export sales by only .88% (1.8% x .49). Further, the Treasury has estimated that only 55% of all U.S. exports passed through DISCs in 1974; therefore, the increase in export sales due to DISC would be further reduced to 0.48% (0.88% x 0.55). Applying this percentage to the total increase in U.S. exports between 1972 and 1975, the Committee concluded that DISC had accounted for only $243 million in additional export sales through 1975, in contrast to an estimated program cost in excess of $1.5 billion for fiscal year 1976 alone.[55] Applying a Bureau of Labor Statistics estimate that each $1 billion in exports generates an additional 34,900 domestic jobs, DISC would have accounted for only 8,500 additional jobs in the United States, under the Committee's analysis.

B. *Report of the Special Committee for U.S. Exports*

A sharply contrasting study on DISC's effectiveness was presented by the Special Committee for U.S. Exports,[56] a pro-DISC organization composed of over three hundred large and small corporations and twenty trade associations. The Special Committee's analysis sought first to determine the effect of the DISC provisions on the cost of capital committed to exports, then to calculate business response to this change in cost of capital, and finally to quantify the effects of these responses on export and employment levels. DISC was estimated to have reduced the cost of export capital by 18.75%, causing a shift of capital and labor from domestic pro-

[53] This figure has been generally adopted and was first used in Houthakker and Mager, *Income and Price Elasticities in World Trade*, REV. OF ECON. & STATISTICS 111, 113 (1969).

[54] Net sales receipts cannot rise in an amount equal to the rise in sales volume because the price drop which causes the increased sales volume partially offsets the increased receipts. For example, a 1% price reduction would, using the figures above, cause a 1.51% increase in sales volume. The percentage increase in sales receipts, however, cannot be 1.51% because the price was reduced by 1%. Rather, the net percentage gain in sales receipts would be the difference between the percentage price drop and the percentage sales volume increase or .51%. The Committee chose a figure of .49%. 1975 HOUSE REPORT, *supra* note 10, at 6.

[55] THIRD ANNUAL TREASURY REPORT, *supra* note 3.

[56] *See* SENATE DISC SEMINAR, *supra* note 44, at 194 (economic analysis of DISC by Dr. Norman B. Ture).

duction into export production with a resulting increase in U.S. export activity.[57] The magnitude of this response to the cost of export capital reduction was measured using a price elasticity of demand analysis that was similar to the method used by the House Committee Report except that much higher values were assigned to the elasticity of demand figures. The Special Committee chose an elasticity of five for all export products except agricultural products, which were assigned a value of ten.[58] Their figures were based on the premise that since most types of U.S. exports represent a small percentage of the total international market volume, any increase in U.S. export volume will have only a minor effect on the world market prices of these goods. Using these elasticity estimates, the Special Committee study estimated that in 1974 alone DISC had increased U.S. exports by $6.3 billion and had added an estimated 365,000 jobs to the U.S. economy.

C. *Department of Treasury Report*

Annual Department of Treasury reports on DISC are required by the original DISC legislation;[59] the most recent study, issued in April of 1976, covers DISC operations between July 1, 1973, and June 30, 1974. The Treasury report sought to isolate DISC impact by assuming that DISC and non-DISC exports are the same in all respects apart from the presence of DISC.[61] Dollar devaluation, floating currency exchange rates, and all the

[57] *Id.* at 195. The report assumes that the aggregate amount of available private capital is not a fixed quantity. Accordingly, the report concludes that even though the DISC provisions will initially cause only a reallocation of capital from domestic to export production, the long term effect of DISC will increase the aggregate amount of private capital. This prediction is based on a determination that as export output increases, demand for domestic products used in the production of exports will increase causing a proportionate increase in capital allocations to that area of domestic production. Thus, the lower cost of capital caused by DISC will not be confined to the export sector, but will be diffused throughout the entire economy, causing an increase in the aggregate capital of the private sector. *Id.* at 200-01.

[58] *Id.* at 195. These elasticities, according to the study, erred, if at all, on the conservative side. It was considered quite possible that actual elasticity of demand figures could be higher than the ones chosen. The difference in magnitude of the elasticity figures used in the Special Committee report and those used in the House Committee study partially accounts for the wide variance in the estimated effects of DISC reached by the two studies.

[59] Revenue Act of 1971, Pub. L. No. 92-178, § 506, 85 Stat. 497, 574 (1971).

[60] THIRD ANNUAL TREASURY REPORT, *supra* note 3.

[61] THIRD ANNUAL TREASURY REPORT, *supra* note 3, at 29. The Treasury stated four assumptions upon which their analysis of DISC would proceed:

(1) DISC and non-DISC exports are equally affected by all economic events apart from DISC; (2) the growth rate for all exports by affiliated groups of corporations which have DISCs in excess of the growth rate for exports of similar products by non-DISCs reflects the DISC stimulus, even though part of any group's exports may not be sold through the DISC; (3) for a period of years, firms which establish a DISC should experience a faster export growth rate than firms without a DISC; (4) the DISC effect equals the difference between actual United States exports during a given accounting period and an estimate of the level of United States exports had all firms experienced the same export expansion as non-DISC exporters since 1971 (the last year before introduction of DISC).

other factors affecting U.S. export trade were assumed to have the same effect on DISC as on non-DISC exporters. The portion of increased U.S. exports attributable solely to DISC was calculated by computing a hypothetical estimate of what total U.S. exports would have been if all exporters had experienced the same export expansion as non-DISC exporters had since 1971. This hypothetical total export estimate was then subtracted from the actual total of U.S. exports and the difference assumed to be solely attributable to DISC. Utilizing this method of analysis, the Treasury cautiously estimated that DISC increased U.S. exports by $4.6 billion through 1974 while adding a possible 230,000 jobs to the U.S. domestic economy.[62]

IV. THE 1976 AMENDMENTS TO DISC

Amid the confusion reflected by these conflicting estimates of DISC's effectiveness, Congress restructured the DISC program as part of the Tax Reform Act of 1976. The amendments represent an attempt to reconcile both the view that DISC had been an effective export incentive and the argument that DISC had served only as a tax haven for exporters.

A. *Prior Legislative History*

DISC had originally been proposed in connection with the Trade Act of 1970.[63] The provisions of that Act would have allowed a DISC corporation, after a three-year phase-in period, to defer taxation on one hundred percent of its export-derived income. When the program passed in the House but failed to pass in the Senate, DISC was reintroduced in the Revenue Act of 1971, but with markedly different characteristics. The House version of the 1971 Revenue Act[64] allowed tax deferral only on the portion of export income which exceeded income attributable to a base period level of export gross receipts.[65] The proposal provided that the base period level

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[62] *Id.* at 33. Treasury goes to great length to state that their estimates of DISC effect are not unassailable conclusions. Again, the fundamental assumption is that DISC and non-DISC exports are the same in all basic aspects except for the presence of a DISC. This assumption, Treasury points out, may not be valid in all cases. There may be differences between DISCs and non-DISCs in areas such as product lines, company size and desire to export. Further, the Treasury approach makes no allowance for the effect of floating exchange rates. *Id.* at 31. Treasury uses the same cautious approach in its estimate of the number of jobs created by DISC, pointing out that under the economic circumstances of the 1973-74 period "it is probable that some of the additional exports generated by DISC were at the expense of domestic sales, and did not contribute to overall employment levels." *Id.* at 33.

[63] H.R. 18970, 91st Cong., 2d Sess., §§ 401-08 (1970).

[64] H.R. REP. No. 92-533, 92d Cong., 1st Sess. 3, *reprinted in* [1971] U.S. CODE CONG. & AD. NEWS 1827 [hereinafter cited as 1971 HOUSE DISC PROPOSAL].

[65] The base period approach was designed to met objections that allowing a deferral on all export earnings as proposed in the 1970 DISC program would constitute a windfall to exporters since they would be allowed to receive tax deferral benefits on activity they presumably would have engaged in even without the DISC incentives. *See generally Hearings on Tariff*

was to be seventy-five percent of the average export receipts for 1968, 1969, and 1970. The export gross receipt figures used for the base period calculations were to be those of the DISC's parent, since no DISCs were in existence during the base period years. Once the base period figure was calculated, the portion of income deemed distributed to the DISC shareholders, and therefore currently taxable to them, was to be equal to the ratio of the base period level to the current year export level. Using the House Committee's example to demonstrate the method of calculation, assume a DISC parent has a base period export receipt level of $100 from its export activities during the base period years of 1968 through 1970, and a current year export receipt level of $150. Assume further that the DISC's taxable income for the current year is $6. The amount of this taxable income deemed distributed because attributable to the base period would be $6, multiplied by the ratio of the base period level to the current export level (100/150, or 2/3). Therefore, the amount of currently taxable income would be $4 ($6 x 2/3). The DISC would then be allowed to defer from current taxation $2 of its income. The intended effect of the base period approach was obviously to limit favorable tax deferral treatment to the income which represented an increase in export activity above and beyond the base period level of activity and to provide an incentive for continuing to increase export activity by allowing tax deferral treatment on all of the income resulting from the increase.

The Senate saw serious problems in the base period approach, believing that the method would raise "substantial equity and administrative problems."[66] Accordingly, it rejected the House approach and proposed simply to restrict deferred tax treatment to one-half of the export income of the DISC. Thus, under the Senate plan, a DISC with $6 of export-related income would be deemed to have distributed $3 (50%) of its income to its shareholders, regardless of the prior export activities of its parent. The mechanical Senate approach prevailed, and until the Tax Reform Act of 1976, the principal deemed distribution category of the DISC tax structure was one-half of the DISC's taxable income.[67]

B. *1976 Legislative History: Proposals and Compromises in Congress*

Faced with much higher than anticipated DISC cost[68] in terms of fore-

and Trade Proposals Before the House Comm. on Ways and Means, 91st Cong., 2d Sess., pt. 9, 2585-96 (1970) (statement of Alan Schenk). Thus, the 1971 House DISC proposal would have denied tax deferral benefits on export income which was attributable to the level of export activity existing before DISC and would have conferred such benefits only on the increment of export income which was above this base period level.

[66] S. REP. No. 92-437, 92d Cong., 1st Sess. 11, *reprinted in* [1971] U.S. CODE CONG. & AD. NEWS 576 [hereinafter cited as 1971 SENATE DISC PROPOSAL].

[67] I.R.C. § 995(b).

[68] *See* THIRD ANNUAL TREASURY REPORT, *supra* note 3, at 23, which shows actual revenue reduction attributable to DISC to have been $350 million in 1972 and $720 million in 1973.

gone tax revenues and with conflicting claims of DISC benefits, Congress in 1976 returned to the base period approach in an attempt to make DISC "more efficient and less costly."[69] The amendments proposed in the House[70] called once again for the base level to be seventy-five percent of the average of the export receipts of the DISC during three base period years, but a significant change was added to the base period concept. For taxable years 1976 through 1980, the base period years were to be 1972, 1973, and 1974; but beginning in 1981, the base period would move forward one year for each subsequent taxable year, maintaining its three-year span but trailing the current taxable year by six years.[71] Hence, the base period for taxable year 1981 would be the years 1973, 1974, and 1975.

The Senate accepted the moving base period concept but substituted different parameters for its calculation. The Senate version called for a base period level of sixty percent of the average of the export gross receipts for the base period, with the base period to consist of three out of four available taxable years.[72] In order to prevent distortion of the base period level caused by abnormally high export volume in one of the base period years, the DISC was to be allowed to choose the three base period years from the four available. The initial base period years chosen by the Senate were 1973, 1974, 1975, and 1976. The four-year base period was to remain stationary until 1979, at which time the base period would move forward one year for each taxable year, lagging the current taxable year by three years. Therefore, in 1980 the base period years would be 1974 through 1977 and in 1981 the base period years would be 1975 through 1978. Thus, in 1976 the Senate adopted the deemed distribution of income concept that in 1971 it had rejected in the interests of equity and simple administration.

A Conference Committee compromise[73] resulted in the final formulation of the base period parameters which became law under the Tax Reform Act of 1976. These amendments[74] provide that the base period level is to be sixty-seven percent of the average of export gross receipts during the

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The 1971 House proposal estimated DISC cost at only $100 million in 1972 and $200 million in 1973. Thus, actual DISC cost far exceeded the congressional estimates made at the time of DISC enactment. *See* 1971 HOUSE DISC PROPOSAL, *supra note* 64, at 3.

[69] *See* note 20 *supra* and accompanying text.

[70] 1976 HOUSE DISC PROPOSAL, *supra* note 20, at 3158.

[71] The six year span used here refers to the span between the current taxable year and the most recent year of the base period. Since the base period consists of more than one year, the actual lag period may be six, seven or eight years depending upon the base period year referenced.

[72] S. REP. No. 94-938, 94th Cong., 2d Sess. 291, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3439, 3721 [hereinafter cited as 1976 SENATE DISC PROPOSAL].

For DISCs which exported agricultural products, the three base period years were to be chosen from among five available years. *Id.* at 293, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS at 3723.

[73] H.R. REP. No. 94-1515, 94th Cong., 2d Sess. 473, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 4118, 4178.

[74] 1976 DISC amendments, *supra* note 19.

base period years. The initial base period consists of the four taxable years of 1972 through 1975. The base period remains stationary until 1980, when it will move forward one year for each taxable year, lagging the current taxable year by four years. Thus, the base period for 1980 will be the years 1973 through 1976 and for 1981 it will be 1974 through 1977.

C. *The Impact of the 1976 DISC Amendments*

This section will examine the impact of the new base period distribution structure of the 1976 DISC amendments and its probable effectiveness in accomplishing the stated congressional goal of making DISC less costly while maintaining an incentive for increased exports. Specifically, the base period provisions will be examined to determine how their effect is altered by two important aspects of the new income distribution structure. The first is a provision which allows a DISC with no export receipts during a base period year to use an export receipts amount of zero for that year in computing its base period level.[75] Examples will be used to demonstrate that this provision can have a substantial effect upon the amount of income distributed by the base period rule. The second aspect of the base period distribution scheme which may affect accomplishment of the congressional purpose is the retention of the rule which deems one-half of DISC income distributed. This rule is in addition to the provision for the base period distribution. Apparently, neither the House nor the Senate sought to substitute the base period distribution for the fifty percent of DISC income distribution;[76] both distributions were simply added together so that now a DISC must first distribute any income attributable to base period export activity and then distribute one-half of the balance of the income. This aspect of the DISC income distribution structure will be examined to determine the effect it may have on the DISC program as an incentive to increase exports.

1. *Zero Export Receipts.*—Addressing first the consequences of the zero export receipts rule, the examples set out below demonstrate both the effects of the base period distribution rule itself and how those effects are modified through interaction with the zero export receipts rule. These examples assume, unless otherwise indicated, a non-growth DISC which has had export receipts of $1,000 for each year of its existence.[77] Presumably, this static DISC would be precisely the type of DISC Congress

[75] I.R.C. § 995(e)(6) *as amended.*

[76] Recall that the base period distribution and the 50% distributions were alternative measures when DISC was reintroduced in the Revenue Act of 1971. While many other alternatives to the 50% distribution were discussed during the formulation of the 1976 DISC amendments, the option of substituting a pure base period for the 50% income distribution was apparently not raised. *See generally Hearings on Tax Reform, supra* note 49; 1975 HOUSE REPORT, *supra* note 10.

[77] Treasury is charged under the 1976 DISC amendments with prescribing necessary regulations to deal with the problem of short taxable years, that is, those years where the DISC

sought to exclude from further tax deferral benefits. As the examples show, however, this exclusion does not always occur. To evaluate the impact of the base period rule, the examples will calculate the percentage increase in deemed distribution income which is attributable to base period export activity. This percentage increase in distributed income, over and above the fifty percent of DISC income distribution, is simply the ratio of the base period export receipts figure to the current year's export receipts.[78]

Example 1: Assume a non-growth DISC which began operations in 1972. Under the 1976 DISC amendments, the base period amount is calculated by averaging the export receipts for all of the base period years (1972 through 1975), and calculating sixty-seven percent of that average. Thus, the base period level is equal to:

$$0.67 \times \left(\frac{\$1,000 + \$1,000 + \$1,000 + \$1,000}{4}\right) = \$670$$

Assuming export receipts of $1,000 in 1976 (as in all prior years), the percentage increase in deemed distributed income because of the base period rule is the ratio of the base period figure to the current year's receipts—670/1,000, or sixty-seven percent.

Example 2: Assume the same conditions described above, except that the DISC began operation in 1973. Because this DISC had no taxable year during the 1972 base period year, it will be allowed under 1976 amendments to use an export receipts amount of zero for 1972. Therefore, for any taxable years prior to 1980, the resulting percentage increase in deemed

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may have less than a full year of export activity, and hence, export receipts. Treasury also is authorized to prescribe annualization of a short year for base period calculations. Thus, benefits of short year export receipts may be denied, but this will not affect the zero export receipts rule. *See* I.R.C. § 995(e)(7).

[78] The total combined base period and 50% income distributions may be expressed by formula as follows:

ti = taxable income

ti_{bp} = taxable income attributable to base period activity

egr = current year export gross receipts

bp = base period export gross receipts level

dd = total deemed distribution attributable to the base period rule and the 50% of DISC income rule

$$dd = ti_{bp} + \tfrac{1}{2}\left(ti - ti_{bp}\right)$$

$$\text{where } ti_{bp} = ti \times \frac{bp}{egr}$$

$$\text{then } dd = \left(\tfrac{1}{2}\, ti \times \frac{bp}{egr}\right) + \tfrac{1}{2}\, ti$$

$$\text{and } dd = \tfrac{1}{2}\, ti \times \left(\frac{bp}{egr} + 1\right)$$

Thus where bp = 0 the deemed distribution is 50% of the DISC's taxable income. Conversely, where bp = egr, the deemed distribution would be the total amount of DISC income. Therefore, no DISC income would be subject to tax deferral benefits.

distribution income attributable to the base period rule will be only 50.25%. This reduction from sixty-seven percent in the amount deemed distributed occurs because the zero gross receipts for 1972 lowers the base period amount to $502.50:

$$0.67 \times \left(\frac{\$0 + \$1{,}000 + \$1{,}000 + \$1{,}000}{4}\right) = \$502.50$$

Thus, simply because this DISC began operations a year later than its otherwise identical counterpart, it receives a tax benefit in the form of a substantial reduction of deemed distributed income attributable to base period activity.

Example 3: Assume a DISC that is identical to the one described in *Example 1*, except that it began operations in 1974. Using zero export receipts for the base period years of 1972 and 1973, this DISC will have only a 33.5% increase in deemed distributed income attributable to the base period rule for any taxable year prior to 1980:

$$0.67 \times \left(\frac{\$0 + \$0 + \$1{,}000 + \$1{,}000}{4}\right) = \$335.$$

Example 4: An otherwise identical DISC which began operations in 1975 will have a percentage increase in deemed distributed income of only 16.75% attributable to the base period level for any taxable year prior to 1980:

$$0.67 \times \left(\frac{\$0 + \$0 + \$0 + \$1{,}000}{4}\right) = \$167.50.$$

Example 5: A DISC that began operations in 1976 or later will have an even greater advantage over the DISCs discussed above. For four years post-1975 DISCs will have no base period years and hence a zero percentage increase in deemed distribution over the one-half taxable income deemed distribution. Further, at the end of the four-year period these DISCs will enjoy three additional years during which at least one of the base period years will be zero, which will substantially reduce the base period level. For example, a DISC that begins operations in 1977 will have, from 1977 until 1979, a stationary base period of 1972 through 1975. In 1980, the base period will move forward one year to span 1973 through 1976, but this one-year shift still fails to include any years of the 1977 DISC's life. Thus, the 1977 DISC will enjoy four years (1977 through 1980) of zero base period distributions. Further, in 1981 the base period will move forward one year to cover 1974 through 1977, including only one year of actual DISC operation. Therefore, until the lagging base period spans a time during which the DISC was in existence all four years, the DISC will enjoy a substantial reduction in base period deemed distributions. Not until 1984, eight tax years after the 1977 DISC was created, will the base period level reflect a full four years of actual DISC export activity.

These examples demonstrate that DISC treatment under the base period rule may vary substantially solely on the basis of when the DISC began operations. DISCs formed in 1976 or later will receive no additional advantages in relation to each other regardless of the year in which they were formed, but all will enjoy distinct advantages over earlier DISCs.[79]

This inequitable treatment could have been avoided through adoption of a component of the 1971 base period proposal which included the export gross receipts of the parent or related company in base period calculations.[80] Had this approach been adopted in the 1976 amendments, a corporation engaged in export activity without a DISC would not be able to claim a base period level of zero for four years if the corporation formed a DISC in 1976 or thereafter. Instead, the parent would be required to use its own export gross receipts from the base period years for base period calculations.[81] This approach would alleviate a substantial portion of the inequality that presently exists under the 1976 amendments. Congress never expressed an intention to grant special advantages to newer DISCs, but such an effect is clearly present.

The potential for abuse of this presumably unintended anomaly in amendments is substantial. Although the percentage of total U.S. exports funneled through DISC has grown from 40.3% in 1972 to an estimated 75% in 1976,[82] a considerable portion of U.S. exports not yet under DISC could fall within the zero export receipts rule.[83]

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[79] An argument could be made that the 1976 DISC amendments are intended to give the newer DISCs the initial benefits enjoyed by their predecessors, but this argument is specious on two grounds. First, the zero export receipts rule goes further than establishing equal treatment of old and new DISCs; it actually gives substantially more tax benefits to the new DISCs. A 1972 DISC enjoyed four years of no base period distributions but was taxed on a full base period amount. By contrast, a 1976 or later DISC will enjoy four years of zero base period distributions and then three additional years of partial base period computation. Only in its eighth year of operation would this new DISC feel the full consequences of the base period rule.

Second, and more importantly, the 1976 DISC amendments were passed to remedy a perceived defect in the DISC income distribution structure. This defect should be remedied as quickly and as equitably as possible. It seems illogical to say a remedy for a defective tax structure must be shaped to allow all present and future paticipants in the tax program a chance to benefit from the defect.

[80] 1971 HOUSE DISC PROPOSAL, *supra* note 64, at 81.

[81] The 1976 DISC amendments adopt a closely analogous approach in the anti-avoidance rules designed to prevent a DISC shareholder from artifically reducing the export receipts of its DISC during the base period years. I.R.C. § 995(e)(8)—(10). These new amendments give the Secretary of the Treasury broad power under certain circumstances both to aggregate gross export receipts of DISCs and to attribute the base period level of one DISC to the base period of another by going through the common shareholders of the two DISCs. *See generally* Gourevitch, *DISC's Ability to Defer Taxes on Income Restricted by Tax Reform Act of 1976*, J. OF TAX. 9, 10 (Jan. 1977). Clearly a rule requiring integration of the parent's export receipts during the base period into the base period equation is no more complex than these special rules and would serve an equally beneficial purpose, *i.e.*, prevention of a substantial tax advantage accruing to one enterprise over another when there is no rational basis for the differentiation.

[82] THIRD ANNUAL TREASURY REPORT, *supra* note 3, at 27, 35; GATT REPORT, *supra* note 6, at 133.

[83] While it is doubtful that all United States exports will ever be channeled through DISC,

2. *Deemed Distribution.*—A second troublesome aspect of the 1976 DISC amendments is the retention of the provision requiring deemed distribution of one-half of the DISC's taxable income in addition to the deemed distribution of any income attributable to the base period export level. To return to the earlier examples, assume the 1972 DISC had a taxable income of $100. Under the old provisions $50 would have been deemed distributed. Under the 1976 amendments the amount deemed distributed is calculated by first determining the amount of income deemed distributed due to base period export activity—sixty-seven percent of the $100, or $67. The remaining $33 is subject to the mechanical one-half deemed distribution rule; accordingly, another $16.50 is deemed distributed. Thus, under the 1976 provisions the total deemed distribution is $83.50, a sixty-seven percent increase over the pre-1976 deemed distribution of $50. It must be emphasized that the fifty percent deemed distribution rule was inserted into the DISC program by the Senate in 1971 as an *alternative* to the base period rule—in the interests of equity and simple administration. If these interests did not prevent adoption of the base period distribution provision in 1976, it would seem that equity and simple administration no longer justify retention of this arbitrary fifty percent distribution scheme. In addition to adding unneeded complexity[84] to the DISC tax structure, the fifty percent distribution rule serves in large part to negate the intended effect of the base period distribution provision. A DISC which increases its exports above its base period level cannot defer taxation on all of the income attributable to the real increase in export activity. Rather, one-half of that income must be distributed, even though attributable to a genuine rise in export sales. If the congressional goal is in fact to maximize incentives for increased exports, then the portion of income above the base period amount, that is, that portion of the income which is attributable to an actual increase in exports, should be allowed complete tax deferral benefits. If Congress feels that the present base period computations tax too small an amount of DISC income, the methods of base period calculation should be adjusted to increase the base period amount.[85] However, increases in the DISC tax base

the continued growth of DISCs (124 DISCs were formed in January and February of 1976 alone, *see* THIRD ANNUAL TREASURY REPORT, *supra* note 3, at 27) indicates that the potential use of DISC as an export vehicle has not been fully exhausted. While these new DISCs may evidence the entry of new companies into the export market, they also may be corporations merely changing their method of exporting.

[84] The DISC provisions have been called some of the most complex in the United States tax structure. *See generally Hearings on Tax Reform*, *supra* note 49, at 2323 (statement of Michael J. McIntyre); Considine, *supra* note 52, at 222.

[85] For example, (1) the base period amount could be raised to 75% or more of the average of the export receipts for the base period years, or (2) the base period could be moved so as to trail the current year by only one or two years, thus more accurately reflecting recent export performance. There are an infinite number of ways to structure the base period so as to achieve the desired base period income distribution level. The point is that once a base period is established, a DISC which increases exports above that base period should be allowed to defer taxation on all income attributable to that increase in export sales. Such deferral would

should not be made by the addition of an inflexible factor to the deemed distribution equation. Such action is completely at odds with the base period approach and substantially reduces the incentives to increase exports contained in the base period approach.[86]

D. *Summary*

The 1976 amendments represent an attempt by Congress to fine-tune the DISC tax vehicle. Congress sought to effectuate a policy determination that tax deferral benefits of large and medium-sized DISCs[87] should be related to and limited by the amount that the DISC increases its export receipts during each taxable year over a determinable base amount. While the base period rule does not ensure that increased exports are caused by DISC, it does attempt to deny tax deferral benefits to those DISCs which fail to increase their export activity. By limiting DISC benefits to increased exports, Congress sought to create a forceful incentive to expand export operations.

The accomplishment of these base period objectives is hampered by two features of the 1976 DISC amendments. First, the zero export receipts rule gives substantial yet unexplained and unjustified preferential tax treatment to more recently created DISCs. Congress could have avoided this distinction by requiring DISC parents to include their own base period export receipts in base period calculations. This approach would deny the favorable zero export receipts treatment to those exporters who in fact engaged in export transactions prior to the creation of their DISCs but would preserve the incentive for new exporters to enter the export market. A company which did not engage in any export transactions prior to the creation of its DISC would continue to receive the favorable treatment accorded by the zero export receipts rule, a strong incentive for companies

maximize the incentive to increase export activity. While an incentive to increase exports is present under the existing DISC income distribution structure, it is substantially diminished by the required distribution of 50% of the increased income.

[86] It may be that the political exigencies which existed when DISC was under scrutiny were such that no one was in a position to articulate this approach. The supporters of DISC may have felt that the best approach was to push for the expansion, or at least the maintenance, of present DISC benefits. *See Hearings on Tax Reform*, *supra* note 49, at 2264 (1975) (statement of Raiferd L. Drew). Likewise, disparagers of DISC may have felt that the best approach was to press for complete DISC repeal. *See id.* at 2321 (statement of Michael J. McIntyre).

[87] I.R.C. § 995(f), a 1976 DISC amendment, will operate to exclude some DISCs from the base period rule. A "small DISC" (one with an adjusted taxable income of $100,000 or less) will not be subjected to the base period distribution. Rather, its primary deemed distribution will continue to be 50% of its taxable income. This small DISC exception is phased out with increased DISC income so that a DISC with an adjusted taxable income of $150,000 or more receives no small DISC benefits. The legislative history of this section reveals no special reason for the small DISC exception, but it is apparent that Congress intended to encourage small businesses to enter the export market. While the small DISC provision will exclude possibly 50% or more of all DISCs, it will affect only about 5% of the total taxable income generated by DISCs. *See* THIRD ANNUAL TREASURY REPORT, *supra* note 3, at 26.

heretofore engaged solely in the domestic market to enter the export field. While this suggested approach undeniably would continue to give preferential treatment to some new DISCs vis-a-vis older DISCs, it would limit this preferred treatment to activity representing a genuine increase in the export market level. A company would be denied zero export receipt benefits where its new DISC export activity represented only a change in method, not level, of exporting.

The second hindering feature of the 1976 amendments is retention of the rule that deems fifty percent of taxable income to have been distributed. This rule in conjunction with the base period distribution rule, unnecessarily complicates the DISC taxation scheme and substantially reduces the incentive to increase exports. If Congress felt that the base period distribution formula did not subject a sufficient amount of DISC income to current taxation, a better remedy would have been to change the base period parameters so as to draw the desired level of DISC income into the current distribution category. This approach would have both simplified the statutory structure of the deemed distribution income and provided a much stronger incentive for increased exports. If Congress wishes to stimulate export activity by conferring tax deferral treatment on income derived from increased export activity, none of the income resulting from the increased activity should be subject to immediate taxation. An inflexible distribution of one-half of the DISC's increased income largely negates the stimulus to increase export trade.

V. DISC RETENTION: AN ANALYTICAL FRAMEWORK FOR INQUIRY

While the 1976 DISC amendments exemplify the maxim that politics is the art of compromise, domestic criticism of DISC has not been silenced by the changes,[88] and more foreign criticism may be expected. This section of the Note will formulate an analytical framework within which the paramount policy question of DISC retention may be fairly discussed and evaluated when DISC once again comes under congressional scrutiny. The purpose here is not to answer the question of DISC's viability, but rather to identify and organize the host of complex issues that must be addressed if a reasoned decision by Congress on DISC retention is to be reached. It is suggested that analysis of DISC retention proceed along the following lines:

A. *The Value of Export Stimulation to the U.S. Economy*

Discussion of an export stimulus proposal in this context should assume that the program in question effectively increases export activity. The inquiry must focus on the impact of increased export trade upon the do-

[88] *See* Wall St. J., Jan. 5, 1977, at 1, col. 6.

mestic economy and on the relative merits of alternative ways to use the revenue lost because of the export program.

Critics of export stimulus programs view any export incentive as inherently less beneficial to our internal economy than similar incentives applied to domestic sales because some benefits of the increased export production go to foreign rather than American consumers.[89] A basic inequity arises when the foreign consumer pays less for American products than his American counterpart; if the economic stimulus were applied to the domestic economy, the price inequity would be eliminated. In addition, domestic stimulation, as opposed to export market stimulation, benefits the domestic economy in other ways. Economic stimulation of domestic corporations which compete against importers would decrease our level of imports, thus improving the U.S. balance of trade.[90] Moreover, any efforts which make U.S. industry more profitable and productive will eventually lead to an increase in foreign investments in the U.S. with a resulting improvement in the U.S. balance of payments position.[91]

Supporters of export incentive programs believe that maintaining a high level of export activity is vital to the U.S. economy. Exports now comprise an important segment of our gross national product; any decrease in export activity would obviously have a detrimental effect on the segment of our economy engaged in production of export goods. During times of domestic unemployment, expanded export activity offers an opportunity for increasing domestic employment levels. In addition, some necessary, even vital imports, principally oil and certain raw materials, cannot be economically supplied by the domestic market; hence, exports are necessary to pay for these essential imports and to maintain a favorable balance of trade. Finally, exports are an important source of capital. An expanded export program could provide a substantial portion of the capital the United States needs to continue its economic growth.[92]

B. *The Effectiveness of Export Stimuli in an International System of Flexible Currency Exchange*

Presupposing a decision that increased export activity would be beneficial to the U.S. domestic economy, the inquiry here seeks to ascertain whether export incentives can be effective in a world having a floating or flexible currency exchange.

One view of export stimuli in a floating exchange system maintains that even if incentives are initially effective, their effectiveness cannot be sus-

89 *See* Considine, *supra* note 52; 1975 HOUSE REPORT, *supra* note 10, at 9.
90 1975 HOUSE REPORT, *supra* note 10, at 10.
91 *Id.*
92 *See Hearings on Tax Reform, supra* note 49, at 2287-94 (*Government Support of U.S. Exports: Convenience or Necessity*, a study by Jack Zwick [hereinafter cited as Zwick Study]).

tained over an extended period of time.[93] Currency appreciation, under this view, will eventually offset the effect of increased exports: as exports go up, our balance of trade surplus will rise accordingly; this rise will in turn cause our currency to appreciate on the flexible exchange system, which will cause the price of foreign goods to drop for American buyers and the price of American goods to rise for foreign buyers; these price changes will increase imports and decrease exports until equilibrum in our balance of trade is reestablished. This currency adjustment theory also applies when there is a decrease in our export activity and a resulting deficit in our balance of trade: a balance of trade deficit will cause the dollar to depreciate on the floating exchange; this depreciation will in turn cause the price of foreign goods to rise for American buyers and the price of American goods to drop for foreign buyers; these price changes will increase exports and decrease imports until equilibrium is once again established. The time frame within which the adjustment process would occur has been estimated to range from two to five years.[94]

Critics assert that export incentives not only have a limited period of effectiveness but may cause serious domestic employment problems during the adjustment period as well.[95] They argue that since increased imports caused by currency appreciation generally tend to be in labor-intensive industries, the decrease in similar domestic production caused by these increased imports results in a high rate of domestic unemployment within the affected industry. The net beneficial impact of an export incentive such as DISC upon domestic employment would thereby be greatly decreased. While DISC may create jobs in the export sector, it might also destroy many jobs in other, more labor-intensive domestic industries.

Proponents of export stimulation[96] accept the premise that over the long run an export stimulus of a constant amount may be neutralized by a corresponding rise in currency exchange rates, but they emphasize the short-run benefits. They note that while the international currency system is regaining equilibrium, increased exports create jobs and benefit the U.S. balance of trade. Moreover, they caution that dependence on the floating exchange to correct a balance of trade deficit has serious detrimental effects on the U.S. internal economy. Devaluation adds to inflation within the domestic economy since imports become more expensive.[97] This inflation in turn causes the price of substitutable domestic goods to rise and thereby exacerbates the problem. In contrast, an increase in exports to remedy trade deficits avoids devaluation and its inflationary effects. The

[93] *See, e.g.*, the statements of Robert Sammons and Thomas Horst in SENATE DISC SEMINAR, *supra* note 44, at 22, 38.

[94] *Id.*

[95] *Id.*

[96] *Id.* at 3 (statement of David Garfield); *see generally* Zwick Study, *supra* note 92.

[97] Zwick Study, *supra* note 92, at 2288-89.

proponents of export incentives further maintain that the international monetary exchange system currently does not, in fact, allow currencies to float freely;[98] many currencies are managed by their respective governments in order to maintain a desired rate of exchange. Dependence upon a flexible exchange system to correct our balance of trade problems when the system is not in fact flexible may therefore, be unwise.[99]

A final argument against the currency adjustment theory suggests that an effective system of international trade and exchange must deal with both trade and currency problems.[100] If the currency system is allowed to float freely but the trading system is restrained, then governments may employ trade measures to neutralize the responsive pressures of a floating exchange. Likewise, if trade is free but the currency adjustment process is restricted, imbalances may occur in the currency exchange rates. Thus, a floating currency alone will not solve all balance of trade problems.

C. *Use of Tax Incentives as Export Stimuli*

Assuming a governmental policy decision that export activity can and should be stimulated, the inquiry must turn to whether a tax incentive program is an effective method of achieving that goal. The larger issue questions whether any tax incentive program is useful for implementing a given governmental policy; some tax experts have urged that tax incentive programs be abandoned and replaced by direct government expenditures in the areas of intended stimulation.[101]

Tax incentives are attacked on the ground that such programs are inequitable, often resulting in windfalls to those who would have engaged in the activity regardless of the incentive. Further, tax incentive programs designed to implement non-tax-related goals often divide and confuse congressional consideraton of the program's merits. For instance, any tax incentive proposal must go through the House Ways and Means Committee and the Senate Finance Committee, but these Committees are often ill equipped to handle the substantive areas of concern involved in the tax incentive program.[102]

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[98] *Id.* at 2288.

[99] *But see* SENATE DISC SEMINAR, *supra* note 44, at 22 (statement of Robert Sammons). The position advanced by Mr. Sammons is that the IMF allows member countries only to "lean against the wind" in managing their respective currency exchange rates, and that this limits government intervention to the area of short run fluctuations. Governments can intervene, for example, against intense but limited speculation in their respective currencies; they may not, however, under the IMF rules, intervene in the currency market to manage their respective currency exchange rates over the medium-length or long-run time period. *See also* COUNCIL ON INTERNATIONAL ECONOMIC POLICY, 2D INTERNATIONAL ECONOMIC REPORT 9 (1974).

[100] SENATE DISC SEMINAR, *supra* note 44, at 9 (statement of Harold Malmgren).

[101] *See* Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970).

[102] *Id.* at 728.

The arguments in favor of tax incentives generally take the approach that incentives provide an efficient method of channeling private resources into a given area without a complicated bureaucratic apparatus to oversee the process.[103] Advocates of tax incentives also have substantial precedent in the field of international trade.[104] Export Trade Corporations, [105] Western Hemisphere Trade Corporations,[106] and China Trade Act Corporations[107] all had their origins in tax incentive programs in the export trade area. Indeed, one original argument for DISC was that it was needed to equalize tax advantage between exporters who qualified under one or more of the above acts and those who did not.[108]

In addition, other countries use various tax incentive programs designed to stimulate their exports. Rebate of value taxes, low or nonexistent taxation of repatriated foreign profits, and other tax measures are extensively used by our foreign trading competitors.[109]

D. *DISC as an Effective Export Stimulus Program*

Assuming that Congress concludes that tax incentive programs are well suited for stimulation of export trade, the next step is to determine the present effectiveness of DISC in encouraging export trade. It would seem to be crucial to this determination that an objective cost-benefit appraisal of the DISC program be made. Unfortunately, because of the complexity of the forces which act upon international trade, the export expansion effects of DISC may not be susceptible of precise isolation and measurement. Carefully administered analyses of DISC must nevertheless be regularly performed to furnish continuing insight into the effectiveness of the DISC program[110] and to provide Congress with updated data on DISC performance.

It is important to realize, however, that a determination that DISC is *presently* ineffective does not call for an immediate repeal of DISC. A

[103] *See generally* SENATE DISC SEMINAR, *supra* note 44, at 194 (study by Norman Ture); 115 CONG. REC. S5329, S5330 (daily ed. May 16, 1969) (statement of Senator Percy).

[104] This of course does not demonstrate the effectiveness of tax incentive programs, rather it merely shows a congressional propensity to use tax incentives in export stimulation programs.

[105] INT. REV. CODE of 1954 § 971 (repealed 1971).

[106] INT. REV. CODE of 1954 §§ 921, 922, *as amended by* Tax Reform Act of 1976, Pub. L. No. 94-455, § 1052, 90 Stat. 1647 (1976).

[107] INT. REV. CODE of 1954, § 941, *as amended by* Tax Reform Act of 1976, Pub. L. No. 94-455, § 1053, 90 Stat. 1648 (1976).

[108] H.R. REP. No. 92-533, 92d Cong., 1st Sess. 1, *reprinted in* [1971] U.S. CODE CONG. & AD. NEWS 1825, 1831.

[109] *See Hearings on Tax Reform*, *supra* note 49, at 2297-319 (study by the Special Committee for U.S. Exports).

[110] Treasury is required to publish an annual report on DISC's operation and effect. THIRD ANNUAL TREASURY REPORT, *supra* note 3.

congressional finding that the cost of the DISC program exceeds its benefits would require that the reasons for DISC's ineffectiveness be delineated and closely examined. If DISC is ineffective because of internal structural deficiencies, the solution is to remedy the defects within the DISC framework. If, for example, Congress determines that the cost of DISC in terms of foregone tax revenues exceeds DISC export expansion benefits but concludes that these benefits are substantial, the appropriate remedy is not to repeal DISC but rather to restructure and expand the DISC income distribution parameters so that DISC cost is reduced to the desired level. If, however, the problems associated with DISC are incapable of resolution within the present framework, then DISC should be abandoned. If, for example, all export incentives were found by Congress to be ineffective in an international floating currency exchange system, then retention of a DISC program with high cost and negligible benefits would be unjustified.

E. *International Political Implications: DISC's Value as a Bargaining Chip at GATT Trade Negotiations*

DISC's use as a bargaining tool to gain favorable trade concessions from other GATT members[111] at the upcoming GATT negotiations[112] will probably turn on our trading competitors' evaluation of two aspects of DISC: DISC as an effective export program, and DISC as a viable program in the face of strong domestic criticism. If the GATT members should determine either that DISC is generally ineffective or that its continued existence is threatened by internal criticism, DISC will likely be of little utility to the United States at the upcoming GATT negotiations. Alternatively, if DISC is seen as an effective and politically viable program, it may have substantial value at the negotiations.[113]

It appears that GATT and the European Community have already concluded that DISC is an effective export incentive. DISC, and the tax practices of three European countries in the international trade arena,[114]

[111] *See* SENATE DISC SEMINAR, *supra* note 44, at 12 (statement of Harold Malmgren); Zwick Study, *supra* note 92, at 2292-94. *But see* SENATE DISC SEMINAR, *supra* note 44, at 31 (statement of Thomas Horst); *Hearings on Tax Reform*, *supra* note 49, at 2323 (statement of Michael McIntyre).

[112] The most recent GATT trade negotiation was the "Kennedy Round" which took place in 1964-67. Those talks resulted in tariff cuts in the 35-50% range. *See generally* KENNEDY ROUND, GENEVA REPORT ON UNITED STATES NEGOTIATIONS, Vols. 1-2 (1968). The next negotiation will be the "Tokyo Round," which, although officially launched by a 1973 Tokyo Declaration, has not been calendared to begin.

[113] It is important to note that the finding of the GATT panel was only a *prima facie* case of nullification or impairment of benefits which other contracting parties were entitled to expect under the General Agreement. In addition, the panel report has not yet been adopted by the GATT Council, and until it is officially adopted the report is not necessarily the view of the Contracting Parties to GATT. Thus, use of DISC as a bargaining tool at GATT negotiations does not, at present, mean the United States has chosen to disregard its obligations and remedies under GATT.

[114] The countries were France, Belgium and the Netherlands.

were recently examined by a GATT panel of tax experts for alleged violations of GATT Article XVI(4),[115] which relates to export subsidies. The panel, after hearing arguments on both sides, stated that the DISC legislation was an export subsidy "which had led to an increase in exports."[116] In reaching this conclusion, the panel assumed that when corporate income tax is reduced with respect to export-related activities and remains unchanged with respect to domestic activities for the internal market, an expansion of export activity follows. The panel also noted that the United States Treasury had acknowledged that DISC had increased exports. Finally, the fact that so many DISCs had been created was itself considered evidence that DISC status conferred a substantial benefit on exporters.[117] Thus, it appears that our trading competitors and GATT have concluded that DISC is an effective export incentive.[118]

It is doubtful that the other members of GATT have reached a firm conclusion as to the political viability of DISC.[119] While the 1976 DISC amendments demonstrate a recent willingness on the part of Congress to keep the DISC program, continued criticism of the program may well lead our export rivals to adopt a "wait and see" attitude. If these countries conclude that Congress will soon abolish DISC on its own, DISC quite clearly will have limited value at the GATT negotiatons.

VI. CONCLUSION

Since its inception, DISC has simultaneously produced both vehement criticism and ardent support. Higher than expected DISC costs and strongly contested estimates of benefits prompted congressional efforts to make the DISC tax vehicle more effective. Two flaws in the 1976 changes, however—the unequal treatment of old and new DISCs and the requirement that one-half of the income derived from increased export trade be distributed—hinder accomplishment of this congressional objective. Further, the congressional deliberations reveal little analysis or orderly treatment of the subtle issues involved in the question of DISC retention.

Since Congress may soon renew its scrutiny of DISC, it is imperative

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[115] *See generally* GATT REPORT, *supra* note 6.

[116] *Id.* at 16.

[117] *Id.* at 15, 16.

[118] Since the other members of GATT do not bear the revenue cost of the DISC program, they need not balance this cost against DISC export benefits in evaluating DISC's effectiveness. Thus, if DISC substantially increases exports, it will be viewed as an effective program by our foreign trade rivals even though the domestic cost of DISC could be so high that the program would be ineffective if evaluated under domestic cost-benefit analysis.

[119] The official reaction of the United States to the GATT Panel finding was that a "mutually satisfactory solution to the problem of the trade distortive effects of tax practices" must be found and that "uncoordinated unilateral changes in domestic law or policy" would not be taken. Office of the Speical Representative for Trade Negotiations, Ambassador Dent Notes GATT Panel Findings, Press Release No. 240 (Nov. 5, 1975). The extent to which our trade rivals find this statement credible is presently undeterminable.

that an objective analysis of all the ramifications of the program be made. While the complexity of both the DISC tax structure and the economic environment in which DISC functions make this a difficult task to perform, such an inquiry is necessary for the proper determination of the important question of DISC retention.

As this Note goes to print, two recent and important developments have occurred which bear on the issue of DISC retention. First, Treasury in its latest report on DISC has modified its procedure for estimating DISC's impact on U.S. export trade. While Treasury continues to calculate DISC's effect on U.S. exports in the manner employed in previous reports, it now calculates the "Net Impact on Total U.S. Exports" as well. This net figure attempts to separate those DISC exports which represent a real increase in U.S. export activity from those which were obtained at the expense of non-DISC exports. Using a "synthesis of the traditional 'elasticity' approach and the approach employed in [earlier Treasury] Reports," Treasury now estimates that the net contribution of DISC to total U.S. exports may have been only $1.0 to $2.5 billion during the period 1972 through 1975. However, under Treasury's previous method of analysis, DISC was estimated to have caused an increase of $7.4 billion in exports through 1975.

In another recent development, the Special Committee for U.S. Exports has shifted the thrust of its arguments to retain DISC. The Special Committee no longer stresses the quantifiable effects of DISC on U.S. export trade, but now emphasizes the prominent role of DISC as an instrument of United States international trade policy. Viewing the current international rules regarding tax-related export subsidies as heavily biased against the United States, the Special Committee feels DISC retention is vital for two primary reasons. First, the GATT panel findings on DISC and on the related tax practices of France, Belgium, and the Netherlands serve as important vehicles through which the United States can exert pressure on other countries to negotiate more equitable international rules of tax-related export subsidies. Second, until fairer international treatment of tax-related export subsidies is obtained, DISC is the only tax benefit available to U.S. exporters to help offset the large tax incentives given to exporters in other countries. The Special Committee thus feels that DISC retention will enable the United States to renegotiate the international rules regarding tax-related export subsidies and thereby achieve more equitable treatment of U.S. exporters vis-a-vis their foreign trading competitors.