DISC TO FSC: A SMALL BUSINESS ALTERNATIVE?

I. INTRODUCTION

In January of 1985, a new export tax incentive became operative in the United States in the form of the Foreign Sales Corporation Act of 1984. The administration proposed the bill intending to achieve four primary objectives: to conform with the General Agreement on Tariffs and Trade (GATT); to maintain revenue neutrality; to avoid increasing the tax currently paid by exporters; and to preserve the ability of small exporters to avail themselves of tax incentives. This Note describes briefly the predecessor to the Foreign Sales Corporation Act, the Domestic International Sales Act, and discusses the reasons for the reduced importance of the Domestic International Sales Corporation. A description of the Foreign Sales Corporation Act follows, including a discussion of how the two laws differ.

II. DOMESTIC INTERNATIONAL SALES CORPORATIONS

As early as 1971, Congress became concerned with problems associated with an increasing balance of payments deficit in the United States. To rectify such problems, Congress created the Domestic International Sales Corporation (DISC) in the Revenue Act of 1971, which was designed to balance the level of competition between domestic and foreign manufacturers. Through the mechanism of the DISC Congress sought to provide a tax incentive for exporters, thereby increasing the level of United States total exports while reducing the balance of payments deficit. Congress also intended the DISC to serve as an instrument to increase both the levels of national income and employment.

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3 See infra notes 136-47 and accompanying text.
6 See, e.g., Note, Tax Incentives to Exportation: Alternatives to DISC, 9 Ga. J. Int'l &
The DISC provided tax incentives for qualified exporting firms through a system of tax deferrals. Thus, a United States firm, by establishing a domestic subsidiary, could earn income exempt from federal taxation. Such income would be taxable only when distributed to the parent corporation or to the DISC shareholders. It should be noted, however, that fifty percent of the DISC's income was deemed distributed to shareholders or parent corporations regardless of whether or not it was actually distributed. The owners of the subsidiary would, therefore, receive the tax advantage of an interest-free deferral of fifty percent of taxable income.

The DISC, which was not required to employ any person or perform any tangible service, was characterized as a "paper company" within the parent's corporate structure. The DISC served only as an accounting entity, through which the parent firm exported its manufactured products.

To qualify as a DISC, an exporting firm was required to comply with five separate criteria. First, the exporting firm had to incorporate within the United States. Second, DISC treatment had to receive approval of the shareholders of a potential DISC. Third, the DISC was allowed to issue only one type of capital stock, which itself was required to have a par value of at least $2,500.

\[\text{COMP. L. 413, 417 (1979).}\]

\[\text{7 I.R.C. § 991 (1982).}\]

\[\text{8 I.R.C. § 995(b)(1) (1982). To qualify under the DISC provisions, a DISC can either have a maximum number of 25 shareholders or, as 75% of the DISC's are structured, exist as wholly owned subsidiaries of large corporations. See infra note 11.}\]

\[\text{9 I.R.C. § 995(b)(1)(D) (1982). The 50% level of deferrable DISC income was altered by the Tax Reform Act of 1976. The 1976 Act changes the scale of deferral to an incremental approach. Deferral is granted to only 50% of a company's income attributable to increases in exports over a base period amount. This structure was further changed by the Tax Equity and Fiscal Responsibility Act of 1982, which reduced the deferral rate on incremental DISC income from 50% to 42.5%.}\]

\[\text{10 RESEARCH INSTITUTE OF AMERICA, THE '71 REVENUE ACT 47 (1971). The DISC can be set up with little capital, no employees, and even no office space.}\]

\[\text{11 According to a report issued by the Treasury in July, 1983, DISCs which had a corporate entity as the majority shareholder comprised 76.9% of all DISCs filing tax returns. Further, such DISCs accounted for 96.3% of all DISC gross receipts, 97.4% of all DISC net income, and 97% of all DISC tax deferred income. The Operation and Effect of Domestic International Sales Corporation Legislation, TREAS. DEPT. ANN. REP. 21 (1981) [hereinafter cited as TREAS. REP.].}\]

\[\text{12 I.R.C. § 992(a)(1) (1982).}\]

\[\text{13 Id. § 992(a)(1)(D) (1982).}\]

\[\text{14 Id. § 992(a)(1)(C) (1982). The } \$2,500 \text{ limit exists to insure that the corporation qualifies as a DISC even though it has little capital. The limitation of stock to only one class simplifies the structure of the DISC. If the DISC was allowed to issue more than one class of stock, separate rules would have to be promulgated specifying how the earnings would be}\]
ninety-five percent of the exporting firm's total assets were required to consist of "qualified export assets." Finally, at least ninety-five percent of the exporting firm's receipts must have arisen from "export-related assets."

As a congressional objective, the compliance requirements were intended to insure that a DISC's income would be derived exclu-


A "qualified export asset" is:

(1) export property;
(2) assets used primarily in connection with the sale, lease, rental, storage, handling, transportation, packaging, assembly, or servicing of export property, or the performance of engineering or architectural services . . . or managerial services in furtherance of the production of qualified export receipts;
(3) accounts receivable and evidences of indebtedness which arise by reason of transactions of such corporation . . . ;
(4) money, bank deposits, and other similar temporary investments, which are reasonably necessary to meet the working capital requirements of such corporation;
(5) obligations arising in connection with a producer's loan;
(6) stock or securities of a related foreign export corporation;
(7) obligations issued, guaranteed, or insured, in whole or in part, by the Export-Import Bank of the United States or the Foreign Credit Insurance Association in those cases where such obligations are acquired from such Bank or Association or from the seller or purchaser of the goods or services with respect to which such obligations arose;
(8) obligations issued by a domestic corporation organized solely for the purchase of financing sales of export property pursuant to an agreement with the Export-Import Bank of the United States under which such corporation makes export loans guaranteed by such bank; and
(9) amounts on deposit in the United States that are utilized during the period provided for in, and otherwise in accordance with, regulations prescribed by the Secretary or his delegate to acquire other qualified export assets.

I.R.C. § 993(b) (1982).

A qualified export receipt is:

(A) gross receipts from the sale, exchange, or other disposition of export property,
(B) gross receipts from the lease or rental of export property, which is used by the lessor of such property outside the United States,
(C) gross receipts for services which are related to any qualified sale, exchange, lease, rental, or other disposition of export property by such corporation,
(D) gross receipts from the sale, exchange, or other disposition of qualified export assets,
(E) dividends with respect to stock of a related foreign export corporation,
(F) interest on any obligation which is a qualified export asset,
(G) gross receipts for engineering or architectural services for construction projects located outside the United States, and,
(H) gross receipts for the performance of managerial services in furtherance of the production of other qualified export receipts of a DISC.

I.R.C. § 993(a) (1982).
sively from exporting activities. Further, Congress hoped to encourage reinvestment of nondistributed income when it provided for deferral of federal income tax on DISC‐earned income. With the nondistributed income invested into other exporting activities, the aggregate level of United States exports accordingly would rise. Increased exports would result in a reduction of the United States balance of payments deficit, while increasing the level of national income.

The release by the Treasury Department in July of 1983 of the "1981 Annual Report on DISC" confirmed the success of the DISC in increasing United States exports. The Department reported that the level of exports increased between seven and eleven billion dollars because of the DISC provisions. In addition, for each additional billion dollars of income, 30,000 new jobs had been created. According to the Treasury Department, however, the addition to national income and the increased employment rate were not without costs; the total tax revenue loss due to the DISC provisions amounted to 1.65 billion dollars.

The Department's estimate, however, may have been inaccurate. The Treasury's method of calculation was purely "mechanical" and, thus, flawed because it overstated direct revenue losses due to tax‐deferred DISC income. The criticism of the Treasury's method of calculation is due in part to its failure to recognize indirect revenue gains brought about by the DISC and an increase in economic activity associated with such gains. Further, the

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19 Id.
20 I.R.C. § 995(d) (1982). Nondistributed DISC earnings which earned income from foreign investment is exempt from taxation, whereas income earned from nondistributed earnings not attributable to foreign investment is fully taxable.
21 S. REP. No. 437 at 91-92, reprinted in 1971 U.S. CODE CONG. & AD. NEWS at 1997-98. Congressional intent was to raise the level of exports.
23 TREA. REP., supra note 11.
24 Id. at 13. For a full analysis of the direct impact DISC has on the level of United States trade, see generally id. at 8.
26 TREA. REP., supra note 23, at 17.
28 Id. at 218.
29 Id. at 219.
Treasury's method failed to account for any indirect impact on budget outlays stemming from changes in economic activity due to the DISC.\textsuperscript{30}

An independent study, commissioned by a collection of business organizations, reported that for every dollar lost in tax revenue, \$1.24 was earned. The twenty-four cent profit was earned because indirect impacts became gains in the tax system.\textsuperscript{31} The study utilized the "partial feedback approach",\textsuperscript{32} to calculate true tax revenue, and discovered that the DISC actually increased tax revenue.\textsuperscript{33} The study is most accurate when manufacturing plants were not at full capacity, and unemployment was greater than zero.\textsuperscript{34} Thus, under the "partial feedback approach," the actual cost to the Treasury in terms of revenue was zero.

The DISC provisions were not without their critics. Some economists criticized the DISC's failure to comply with its primary objective of decreasing the foreign trade deficit.\textsuperscript{35} By their view, income and employment figures did not increase in real terms.\textsuperscript{36} Cited as the primary reason for the DISC's failure was the switch to the system of floating exchange rates.\textsuperscript{37} Floating exchange rates, combined with the dollar's appreciation, rendered the DISC useless as a tax incentive.\textsuperscript{38}

\textsuperscript{30} \textit{Id.} For a description of the Treasury's method of estimating the effect of DISCs on exports, see generally \textit{Treas. Rep., supra} note 11, at 35.

\textsuperscript{31} \textit{Senate Hearing, supra} note 25, at 229. The businesses which commissioned the study were: (1) the American Business Conference, (2) The Business Roundtable, (3) The Emergency Committee for American Trade, (4) The National Association of Manufacturers, (5) The National Foreign Trade Council, (6) The Special Committee for U.S. Exports, and (7) The U.S. Chamber of Commerce.

\textsuperscript{32} The partial feedback approach quantifies the major feedback to the tax incentive. Factors analyzed and quantified are:

1. \textup{Net changes in taxes due to the balance of payments adjustments.}
2. \textup{Net changes in federal, state, and local taxes due to direct and indirect impacts.}
3. \textup{Net changes in tax revenues.}
4. \textup{Net changes in governmental outlays.}

\textit{Id.} at 219.

\textsuperscript{33} \textit{Id.}

\textsuperscript{34} \textit{Id.} at 229.

\textsuperscript{35} \textit{See Considine, supra} note 22, at 221; \textit{Note, supra} note 6, at 423; \textit{see also, Staff of the Joint Committee on Taxation, 98th Cong., 1st Sess., Replacement of the Domestic International Sales Corporations (DISCs) — Description of S. 1804 (Foreign Sales Corporation Act) 40 (Comm. Print 1983) [hereinafter cited as Comm. Print].}

\textsuperscript{36} \textit{Id.}

\textsuperscript{37} \textit{Id. See also Excerpt from Congressional Research Service, Report on Effect of FSC Proposal on Exempt Firms, 21 Tax Notes 255 (Oct. 17, 1983).}

\textsuperscript{38} \textit{See, e.g., Note, supra} note 6, at 423.
When the DISC was first created in 1971, the foreign exchange rate for the United States was constant. In 1976, in Kingston, Jamaica, the United States adopted a floating exchange rate. Consequently, in the context of increasing exports, the floating United States dollar rose in comparison to floating foreign currencies. When the dollar rises, exports become more expensive and imports become less expensive. By the DISC standards, the net effect of the fluctuating and stronger dollar was a nullification of any initial increases in exports.

Other economists found fault in the DISC’s inadequate targets. These critics argued that the benefits of the DISC program were transformed into higher profits which were distributed to shareholders rather than reinvested in capital. Another frequent criticism evolved from the lack of distribution of DISC benefits among all DISCs. According to the 1981 Treasury Department Report on DISCs, 35.2% of the total benefit derived from DISCs went to only twenty-six DISCs, or just .3% of the total number of DISCs. Further, half of the total DISC tax benefits went to eighty-nine DISCs, or just one percent of the total number of DISCs. These figures illustrate that the majority of the DISC benefits were enjoyed by a disproportionately small number of the over eight thousand DISCs.

These critics, along with the European Community, also argued that the DISC actually constituted the subsidizing of exports in violation of the General Agreement on Tariffs and Trade (GATT). Article XVI of GATT provides in part that the "con-
tracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product."

In response to the European Community's challenge that the DISC was an illegal export subsidy, the GATT Council convened a panel to examine the issue. In 1976, the panel issued a report for consideration by the GATT Council. The panel's report stated that the deferral of taxable income under the DISC provisions was not a complete exemption. The panel noted, however, that no interest was paid by the DISC on deferred tax. Thus, the panel concluded that nonpayment of interest on deferred tax by the DISC constituted a partial subsidy to United States exports in violation of GATT Article XVI.

III. THE GATT CONTROVERSY

The Foreign Sales Corporation Act is a direct result of the GATT Council's 1981 adoption of the panel's report. An "Understanding" offered by the GATT Council, along with the panel's report, offered three conclusions regarding the tax treatment of export revenues:

1. Income derived from economic processes located outside the territorial limits of the exporting country need not be taxed by the exporting country;
2. Prices in transactions between exporting entities and foreign entities under common control must be determined on an arm's length basis; and
3. GATT does not prohibit the adoption of measures to avoid double taxation of foreign source income.

The "Understanding" paralleled the panel's report allowing a territorial system of taxation, so long as arm's length pricing rules are needed when a supplier or manufacturer sells to a subsidiary distributor. The rules would set a price which approximates a price charged an unre-
were applied to the distribution of income between the DISC and its parent firm.  

The GATT Council's action stimulated proposals within Congress and the Reagan administration to reform the DISC provision so that tax incentives for exporters would be in accordance with the GATT Council's "Understanding." After setting forth three alternatives to the DISC, none of which it deemed adequate, Congress accepted a fourth proposal set forth originally by the Reagan administration. The Administration, in formulating the legislation, styled the Foreign Sales Corporation Act to comply with GATT and three other objectives: (1) to provide for revenue neutrality, (2) to avoid tax increases on exporters, and, (3) to increase the ability of small exporters to avail themselves of the new legislation.

IV. THE FOREIGN SALES CORPORATION

The Foreign Sales Corporation (FSC), like the DISC, is designed to be a subsidiary of a parent corporation. It offers a tax incentive mainly to exporters of manufactured products. While the purpose of the two exporting companies is similar, their structures are quite different. To qualify as an exporting firm, a FSC must meet requirements set forth in three separate categories. These categories are designated as "foreign incorporation," "foreign presence," and "technical." The requirement of foreign incorporation poten-

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55 These three attempts were:
56 The proposal was released to the public in March, 1983. The Foreign Sales Corporation Act was formally introduced into the House and Senate on August 4, 1983. After passing both Houses of Congress in February, 1984, President Reagan signed the bill into law on July 18, 1984, as part of the Deficit Reduction Act of 1984.
57 See Treasury Explanation, supra note 2, at 441 (letter from Ronald Pearlman, Deputy Assistant for Tax Policy, to Chairman Dan Rostenkowski, Chairman of the House Ways and Means Committee and Robert Dole of the Senate Finance Committee).
58 While the scope of products benefited by the DISC and FSC legislation did not vary, the Senate Committee has asked the Treasury for a report on the effect of the inclusion of services under the FSC provisions. For an article advocating the inclusion of services within FSC, see Feenstra, Extending Tax Incentives to U.S. Service Exports: Re-evaluating the DISC Program, 22 Tax Notes 329 (Jan. 23, 1984).
tially has the greatest impact on the FSC’s profitability.

In order to qualify as a FSC, the exporting company must be incorporated outside of the United States; therefore, a FSC can incorporate in any foreign country, or in any possession of the United States. \(^6^9\) This foreign incorporation requirement is the converse of the DISC requirement that incorporation take place within the United States or the District of Columbia. \(^6^0\) Further, the government where the FSC is incorporated must observe an existing exchange of information treaty with the United States regarding income tax. \(^6^1\) The drafters of this requirement intended for it to bring the FSC into conformity with GATT, and, at the same time, to prevent the FSC from incorporating in countries providing “tax havens.” \(^6^2\)

The FSC must also comply with a category of requirements under the heading of “foreign presence.” \(^6^3\) This category includes three more specific requisites, all of which are distinctly different from their DISC counterparts. First, the FSC must maintain an office outside the United States, in a country which meets the tax haven provision. \(^6^4\) Second, the foreign office must maintain a set of accounting books which satisfies the Internal Revenue Code’s accounting requirements. \(^6^5\) Finally, at least one non-resident of the United States must be a member of the FSC’s board of directors at all times. \(^6^6\) The “foreign presence” category is set forth to further insure the FSC’s compliance with GATT and the “Understanding”

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\(^6^0\) I.R.C. § 992(a)(1) (1982).
\(^6^1\) I.R.C. § 927(e)(3) (West Supp. 1985).
\(^6^4\) Id. § 922(a)(1)(D). For the DISC requirements, see supra notes 7-17 and accompanying text.
\(^6^5\) Id. § 922(a)(1)(D). The accounting requirement is found at I.R.C. § 6001 (West Supp. 1985):

Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary or his delegate may from time to time prescribe. Whenever in the judgement of the Secretary or his delegate it is necessary, he may require any person, by notice served upon such person or by regulations, to make such returns, render such statements, or to keep such records, as the Secretary or his delegate deems sufficient to show whether or not such person is liable for tax under this title. Aug. 16, 1954, c. 736, 68A Stat. 731.

promulgated by the GATT Council. 67

The third and final category of requirements which an exporting firm must satisfy to qualify as an FSC is purely technical. While these technical requirements are similar to those imposed under the DISC provisions, the FSC provisions omit the “gross receipts test” 68 and the “qualified assets test” 69 imposed by the DISC program. The simplification of the technical requirements took place so that more small businesses may set up a FSC. 70 First, the FSC can have no more than twenty-five shareholders at one time during any taxable year. 71 Second, the FSC can never issue nor have outstanding preferred stock. 72 Third, shareholders of the FSC must elect to be treated as such. 73 Fourth, the FSC cannot belong to a controlled group of corporations which has an “interest charge DISC” 74 as a member. 75 The simplification of these qualifications should increase the number of small exporters who operate a FSC. 76

Even though the FSC and the DISC appear substantially different, the formulas they include for the determination of exempted income are similar. Only income defined as foreign trade income is eligible for deferral under the FSC provisions. 77 In order to qualify as foreign trade income, revenue derived from Foreign Trading Gross Receipts (FTGR) 78 must meet three tests: the Foreign Management Test, the Foreign Economic Process Test, and a general Derivative of Revenue Test. 79

The Derivative of Revenue Test is the same in both the FSC and the DISC provisions. Foreign Trading Gross Receipts include reve-
nue derived from the following sources: export sales and leases; services which further the sale, exchange, or lease of the export property; engineering and architectural services for construction projects outside the United States, and managerial services for an unrelated DISC or FSC in furtherance of FTGR. The FSC's benefitted exports are the same as the DISC's because their respective revenue provisions are similar. The FSC and the DISC provisions designate different percentages of total receipts which each allows for foreign derivation. Any receipts not considered FTGR under the FSC provisions are taxed as normal income, without the benefit of FSC exemptions. Under the DISC provisions, however, ninety-five percent of a firm's total gross receipts must qualify as FTGR for any receipts to receive the benefit of the DISC provisions.

The Foreign Management Test is the second FTGR test for FSC revenue. To meet the Foreign Management Test, an exporter is required to hold all meetings of the board of directors and all shareholders' meetings outside the United States. All dividends, fees for professional services, and corporate salaries must be drawn from the exporters' principal bank account, which must be maintained outside the United States. The FSC Foreign Management Test is not included in the DISC legislation. The DISC, having been mainly a "paper company" and not subject to similar require-

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80 Foreign Trading Gross Receipts are defined as derived:
(1) from the sale, exchange, or other disposition of export property,
(2) from the lease or rental of export property for use by the lessee outside the United States,
(3) for services which are related and subsidiary to —
   (a) any sale, exchange, or other disposition of export property by such corporation, or
   (b) any lease or rental of export property described in paragraph (2) by such corporation,
(4) for engineering or architectural services for construction projects located outside the United States,
(5) for the performance of managerial services for an unrelated FSC or DISC in furtherance of the production of foreign trading gross receipts described in paragraph (1), (2) or (3).
81 See supra note 58.
84 I.R.C. § 924(b) (West Supp. 1985).
85 Id. § 924(c)(1).
86 Id. § 924(c)(2), (3). The fees include legal and accounting fees. Further, the salaries will include those paid to the members of the boards of directors or other corporate officers.
ments,\textsuperscript{87} violated GATT provisions.\textsuperscript{88}

The Foreign Economic Process Test is the third FTGR test for FSC revenue.\textsuperscript{89} Some of a FSC's economic processes or activities must take place outside of the United States. These activities include: sales promotion, the making of transportation arrangements, the processing of the customer's order, and the assumption of a credit risk.\textsuperscript{90} Not all such activities, however, must take place outside of the United States. Instead, the FSC can elect to meet one of two alternative tests. The first test requires that at least fifty percent of the aggregate costs derived from the five named activities arise outside of the United States.\textsuperscript{91} Alternatively, under the second test, the FSC can choose to conduct business with eighty-five percent of other aggregate direct costs arising from only two activities carried on outside of the United States.\textsuperscript{92} The second test allows a FSC to perform its two least costly activities outside the United States and meet FTGR's Foreign Economic Process Test while maintaining only minimal foreign contact.\textsuperscript{93}

If a FSC is to receive tax benefits, then it must satisfy all of the FTGR tests. Income derived from FTGR constitutes exempt foreign trade income which is either reinvested in other export-related activities or distributed by the FSC to its shareholders or parent corporation in accordance with GATT principals.

The FSC in most cases is a wholly owned subsidiary serving as a distributor of the parent manufacturer's products.\textsuperscript{94} Because the FSC's profits are eligible for favorable tax treatment, a parent corporation might reduce the price for goods it charges the FSC in

\textsuperscript{87} See supra note 11.
\textsuperscript{88} See supra note 51 and accompanying text for the text of the GATT "Understanding."
\textsuperscript{89} I.R.C. § 924(d) (West Supp. 1985).
\textsuperscript{90} Economic process activities include:

1. advertising and sales promotion,
2. processing of customers' orders and the arranging for delivery of export property,
3. transportation from the time of acquisition by the FSC to the delivery to the customer,
4. the determination and transmittal of a final invoice or statement of account and the receipt of payment, and
5. the assumption of credit risk.

\textit{Id.} § 924(e).
\textsuperscript{91} \textit{Id.} § 924(d)(1)(B).
\textsuperscript{92} \textit{Id.} § 924(d)(2).
\textsuperscript{93} The second test is easier and less costly to satisfy. For example, a firm which does little or no advertising and has minimal transportation costs can perform these activities overseas and perform other activities which cost more at home.
\textsuperscript{94} See supra note 11.
order to reduce its overall tax burden.\textsuperscript{95} To prevent such price manipulation, which would surely violate GATT,\textsuperscript{96} Congress provided two methods of price formulation for a parent manufacturer to charge its FSC.\textsuperscript{97} The formulated, or “transfer price,” approximates the price an unrelated supplier would charge the FSC.\textsuperscript{98} The transfer price charged to the FSC is the greater of either 1.83\% of the FTGR derived from the transaction,\textsuperscript{99} or twenty-three percent of the combined income of both the FSC and its parent corporation.\textsuperscript{100} These transfer pricing methods, termed administrative pricing rules, reduce the price allowance to the FSC by forty-six percent from the DISC provisions.\textsuperscript{101} Additionally, if the FSC uses the administrative pricing rules, Congress requires the exporter itself to perform all of the economic process activities\textsuperscript{102} as well as any activities relating to the solicitation, negotiation, or making of

\textsuperscript{95} The parent corporation might take a 50\% loss on a product, thus decreasing its overall income, while also increasing FSC income eligible for tax exempt status.

\textsuperscript{96} See supra note 51 and accompanying text. The text of the “Understanding” calls for arm’s length pricing when the entities are under common control.

\textsuperscript{97} I.R.C. § 925 (West Supp. 1985).

\textsuperscript{98} I.R.C. § 925(a)(3) (West Supp. 1985) states that the taxable income for a sale between an unrelated supplier and a FSC is “taxable income based upon the sale price actually charged (but subject to the rules provided in section 482).” Section 482 provides:

In any case of two or more organizations, trades, businesses owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades or businesses.

I.R.C. § 482 (1982).

\textsuperscript{99} I.R.C. § 925(a)(1) (West Supp. 1985) provides one method for calculating transfer prices: “1.83 percent of the foreign trading gross receipts derived from the sale of such property by such FSC.”

\textsuperscript{100} Id. § 925(a)(2) provides the alternative method for calculating the transfer prices as:

23 percent of the combined taxable income of such FSC and such person which is attributable to the foreign trading gross receipts derived from the sale of such property by such FSC.

\textsuperscript{101} The parallel DISC provision for transfer pricing provides that:

(1) 4 percent of the qualified export receipts on the sale of such property by the DISC plus 10 percent of the export promotion expenses of such DISC attributable to such receipts, or

(2) 50 percent of the combined taxable income of such DISC and such person which is attributable to the qualified export receipts on such property derived as the result of a sale by the DISC plus 10 percent of the export promotion expenses of such DISC attributable to such receipts.


\textsuperscript{102} For a list of economic process activities, see supra note 90.
the contract. The administrative pricing rules are intended to insure that the FSC will comply with the provisions of GATT. The FSC pricing rules are more difficult to satisfy than those under the DISC provisions. The FSC provisions require that the FSC, or a person contracting with the FSC, perform all of the economic process activities. Even though these activities can be performed anywhere, including the United States, the Economic Process Test must still be met for revenue to qualify as foreign trade income. Administrative pricing rules, therefore, impose an extra burden upon a FSC, which a larger exporter can easily handle, but which will interfere with the efforts of smaller exports.

After qualified FTGR is allocated to the FSC, that portion of the FSC's total foreign trade income which is eligible for exemption must be calculated. The method of transfer pricing employed by the FSC determines the percentage of FTGR which is exempt foreign trade income. If the FSC bought the product sold from an unrelated supplier, thirty-two percent of the income derived from the transaction constitutes exempt foreign trade income. As exempt, the income is deferrable and not subject to federal income tax until distributed.

When the price is set by the administrative pricing rules, there is a reduction in the percentage of the FSC's foreign trade income which is exempt from taxation. This method allows only 16/23 of either the foreign trading gross receipts or the combined total income to be exempt. The total exemption under the administrative pricing rules is limited to less than thirty-two percent. This reduction in the total income exempt from taxation is one

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103 I.R.C. § 925(c) (West Supp. 1985). Congress intended the FSC to be more than a “paper company” and this section is one of the guardian provisions.


105 See supra text accompanying notes 90 and 102.

106 I.R.C. § 923 (West Supp. 1985). Foreign trade income is the gross income of an FSC attributable to foreign trading gross receipts. Id. § 923(b).

107 Id. § 923(a)(2).

108 Id. § 923(a)(3).

109 For the FTGR method, 16/23rds of 1.83% is 1.27%. The total exempt foreign trade income under this method equals 1.27% of FTGR.

110 I.R.C. § 923(a)(3) (West Supp. 1985). For the combined income method, 16/23rds of 23% is a total of 16%. The total exempt foreign trade income under the combined income method is 16%.

further step Congress has taken to reduce the overall effectiveness of the DISC and the FSC as tax incentives.

The portion of income eligible for exemption under the FSC provision is, therefore, reduced from the original fifty percent incorporated in the DISC provisions. Before Congress enacted the FSC provisions, the amount of DISC benefits had already been diminished. The Tax Reform Act of 1976 limited DISC benefits to income attributable to export gross receipts in excess of sixty-seven percent of the average gross receipts in a four-year base period. This amendment reduced benefits, in comparison to those under the DISC provisions, by approximately forty percent. Further, under the Tax Equity and Fiscal Responsibility Act of 1982, Congress raised the amount deemed distributed to shareholders from fifty percent to 57.5%. The amendment to the 1976 Tax Reform Act further reduced DISC benefits by an estimated fifteen percent. Under current law, FSC benefits are set at a maximum of two percent of foreign trade income. Realistically, this rate translates into sixteen percent of total income.

The new FSC legislation does not significantly deter large exporters. Since large exporters possess the economics of scale which allow them to recover the additional costs of meeting FSC requirements, none of the large exporters are expected to discontinue their exporting efforts. Large exporters, however, are not the source for any real growth potential in international trade. Real growth in the coming decade in international trade will come from small and medium-sized firms. Small businesses, therefore, are the only major resource available to the United States through which employment may be enhanced by an increase in exporting

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115 TREAS. REP., supra note 11, at 6.
118 TREAS. REP., supra note 11, at 6.
119 House Hearings, supra note 70, at 36-37. These costs include but are not limited to maintaining a foreign office, foreign corporation, foreign members of the board of directors, and a set of foreign books. The DISC, which was required to incorporate in the United States and was not required to meet any foreign economic or presence tests, did not have any similar costs.
120 Id. at 42.
121 Id.
activity. Realizing this potential for growth among small and medium sized firms, Congress has provided in the FSC legislation special incentives for small and medium-sized export firms.

Even though the DISC was a "paper company" requiring little initial outlay, it failed to attract the full number of potential small exporters. Small exporters shunned DISCs for three reasons. First, the benefits these exporters could derive from establishing a separate DISC subsidiary were insufficient when compared to the total amount of a company's export capacity. Second, the DISC involved complex technical requirements concerning the derivation of income and the reinvestment of deferred taxes. Finally, the DISC was subject to complex reporting requirements, along with the qualifications and administrative burdens accompanying the maintenance of a DISC. Small exporters now contend that the FSC's simplified requirements should encourage other small businesses to export.

While simplifying FSC requirements, Congress has also provided two options to encourage smaller companies' participation in international trade. First, Congress provided for a "small FSC." A small FSC by definition receives FTGR of $5 million or less in any one taxable year. Further, it must not be a member of a controlled group of corporations which includes an FSC, unless that FSC is a "regular" FSC. To derive FSC benefits, the small FSCs are not required to satisfy either the foreign management requirements, or the economic process requirement. A FSC, however, must still be incorporated in a foreign country.

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122 House Hearings, supra note 70, at 35 (statement of Evan A. Werling, for the Small Business Council, U.S. Chamber of Commerce).
123 H.R. REP. No. 432, supra note 62, at 1314, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 970. The conferees of the Senate and the House of Representatives stated that they hoped "small business will be given special encouragement and assistance by the Commerce Department in establishing and operating small FSCs." Id.
124 See Senate Hearings, supra note 25, at 252.
126 Id.
127 Id.
128 House Hearings, supra note 70, at 30.
130 Id. § 922(b)(2).
131 Id. § 924(b)(2)(B)(1).
132 Id. § 924(b).
133 See House Hearings, supra note 70, at 30.
The FTGR level of $5 million for a small FSC is arbitrary and was set at such a level solely to appease members of GATT.\textsuperscript{134} A congressional committee raised the level from $2.5 million to include more small businesses.\textsuperscript{135} The new level is still too low and should be raised higher. Since only five percent of total DISC income was derived from exporting firms with $5 million or less in FTGR, the impact that small FSCs have on tax revenues and GATT is negligible.\textsuperscript{136}

The second congressional option involves the "interest charge DISC,"\textsuperscript{137} which is actually a reformation of the old DISC provisions changed to conform to GATT directives.\textsuperscript{138} An exporter must first satisfy "normal" DISC requirements to qualify under the new interest provisions.\textsuperscript{139} Second, the firm can only have $10 million in FTGR.\textsuperscript{140} Any income derived from receipts in excess of $10 million is fully taxable.\textsuperscript{141} Third, no minimum or maximum amount of income must be distributed.\textsuperscript{142} Any income earned by the DISC can, therefore, be deferred indefinitely. The conforming amendment requires that interest be paid on the amount of deferred tax liability.\textsuperscript{143} Deferred tax liability is the amount of tax which would have been paid if all income had been distributed. The interest that an "interest charge DISC" pays equals the base period T-bill rate.\textsuperscript{144}

On its face, the "interest charge DISC" can have the largest im-

\textsuperscript{134} Senate Hearings, pt. 2, supra note 124, at 85. The $5 million level was originally set by the administration at $2.5 million. The Senate Committee raised the original level. H.R. Rep. No. 432, supra note 62, at 1314, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 970.

\textsuperscript{135} Id. at 1316, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 972.

\textsuperscript{136} Senate Hearings, pt. 2, supra note 125 at 193 (statement of Michael Roush).


\textsuperscript{138} See supra notes 50-57 and accompanying text.

\textsuperscript{139} See supra notes 7-17 and accompanying text.


\textsuperscript{141} Id.

\textsuperscript{142} Id.

\textsuperscript{143} "Shareholder's DISC related deferred tax liability" is, in any taxable year of a shareholder of a DISC, the excess of:

(i) the amount which would be the tax liability of the shareholder for the taxable year if the deferred DISC income of such shareholder for such taxable year were included in gross income as ordinary income, over

(ii) the actual amount of the tax liability of such shareholder for such taxable year.


impact on small businesses, since ninety-five percent of all DISCs have less than $10 million in FTGR. The "interest charge DISC" is not helpful for small businesses and should, therefore, be replaced by raising the small FSC level to $10 million. Under the old DISC provisions, a firm received an interest free loan based on fifty percent of its total income. Under the new interest provisions, the exporting firm receives a reduced interest free loan based on one hundred percent of income. Problems no doubt will arise when the "interest charge DISC's" deferred tax liability compounds year after year and the interest becomes too much for the small exporter to bear. The only ways to benefit from the "interest charge DISC" are for small exporting firms to have high rates of return or to be highly leveraged.

Small businesses are beginning to realize that operating an overseas subsidiary like a FSC is a financial gamble. One reason for this situation is that the costs associated with entering a foreign market are prohibitive. These costs, among others, include executive time and travel, administrative time, and advertising. Another intangible which adds to the cost of exporting to a firm without exporting expertise is the inconvenience associated with doing business with a foreign country. A second reason vitiating the advantages of an FSC to small firms is that entering a market in another region of the United States costs much less and provides more security than doing business abroad. The risks of doing business in a domestic market are known, while those same risks are unknown and difficult to ascertain in a foreign country. Although these same financial and business risks exist for the large firm, they exist on a smaller scale because of the diversity and ex-

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146 For a brief explanation of the DISC and amendments brought about by the Tax Reform Act of 1973, see supra text accompanying notes 114-17.
147 Under DISC provisions, a firm with $100,000 of income could receive benefits and defer $50,000 of that income interest free. Under present law, FSCs will have to pay interest on approximately $25,000 at the T-bill rate if they defer just $50,000. The $25,000 represents the estimated tax on $50,000 for a corporation with $100,000 total foreign trade income.
149 House Hearing, supra note 70, at 23. (testimony of Kathleen F. Hagan, Manager of Foreign Trade, Massachusetts Port Authority, on behalf of the Smaller Business Association of New England).
150 Id. at 26.
151 Id. at 35 (testimony of Evan A. Werling).
152 Id. at 27 (testimony of Kathleen F. Hagan).
Small manufacturing firms must reexamine exporting their products in the future. Exporting can help a firm maintain its level of profitability.\textsuperscript{154} Also, a small firm can fall behind in technology if it does not keep abreast of the world market.\textsuperscript{155} There are also compelling reasons for a small manufacturer to export. Due to techniques of more efficient transportation, the domestic market is slowly developing into a world market.\textsuperscript{156} More and more foreign firms are beginning to import, weakening domestic markets. Thus, to remain competitive the United States must expand its exports, while small businesses, similarly, must expand their markets. A small business can with relative ease move into other regions of the United States and compete with other domestic firms. The idea of exporting, however, brings visions of costs, risks, and bankruptcy to the small businessman. Generous incentives\textsuperscript{157} therefore, are needed to encourage and entice the small manufacturer to compete against foreign firms in overseas markets.

V. Conclusion

The purpose of the Foreign Sales Corporation Act is to bring export incentives into conformity with obligations undertaken under GATT. To achieve this purpose, Congress simplified the requirements for maintaining a FSC, especially by eliminating the "export assets" and "gross receipts" tests from the qualifications for benefits as a FSC. The costs of using a FSC, however, have been increased by requiring a FSC to be incorporated and to maintain an office abroad. Because the costs associated with using a FSC have increased, Congress has provided for the "small FSC." A "small FSC" has special exemptions that facilitate a small business' efforts to export. The "small FSC" provisions, however, have been unable to attract a large number of new small manufacturing

\textsuperscript{153} Id.
\textsuperscript{154} Id. at 35 (testimony of Evan A. Werling).
\textsuperscript{155} Id.
\textsuperscript{156} Id.
\textsuperscript{157} Some possible incentives Congress may consider to further refine the DISC and FSC programs are:

- (1) broaden the covered goods to include services offered by "small FSCs."
- (2) waive the foreign incorporation requirement for "small FSCs."
- (3) set a maximum interest rate which the "interest charge DISC" can be charged.
- (4) set up an agency to advise the small businessman who wants to export, but lacks the knowledge to do so properly.
firms into the exporting market.

Because the United States' foreign trade is continuing to grow, Congress should make a special effort to involve more small businesses in exporting. The FSC, with proper changes, would be a useful tool in encouraging the small manufacturer to export. The changes should center around (1) decreasing the small exporter's costs, and (2) dispelling the exporter's concern about entering a new and confusing market. Without small exporters playing an active role in the use of the FSC, the United States has no legitimate hope of increasing its exports in real terms.

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