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UTILIZING THE DISC IN SOME CORPORATE REPATRIATIONS UNDER SECTION 367

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In an effort to help the balance-of-payments deficit, the Revenue Act of 1971 included provisions authorizing creation of Domestic International Sales Corporations. Designed to discourage the continued use of foreign incorporated sales subsidiaries by domestic companies, election of DISC status permits an exporter to take maximum advantage of certain tax deferral provisions. However, the decision to "bring home" foreign sales subsidiaries to a domestic tax haven requires careful evaluation by the parent company. The author analyzes the problems incident to a decision to repatriate foreign subsidiaries and discusses the advantages in utilizing the DISC to overcome them.

INTRODUCTION

More frequently than not, international selling in the corporate form has been conducted by United States companies through a two or three tier corporate structure with additional horizontal brother-sister[1] structures. The domestic advantages of conducting a business in the multiple corporate form include: (1) limitation of liability and investment risk; (2) separation of business activities on functional, geographic, or product lines; (3) the use of separate tax treatment elections; (4) facilitation of future sales of parts of the business; and (5) other tax benefits such as limiting exposure to the collapsible corporation provisions of § 341 of the Internal Revenue Code of 1954 (the "Code"), avoidance of "anti-discrimination" limitations for pension and profit sharing plans, selective use of stock options and other deferred compensation techniques with minimum dilution of current stockholder interests, and reduced exposure to the personal holding company tax consequences.[2] For the domestic parent,

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1. Tiers refer to corporate subsidiary levels below the parent: *i.e.*, the domestic company (parent) establishes a wholly owned foreign subsidiary (first tier) which in turn establishes a wholly owned foreign subsidiary (second tier) which in turn establishes a wholly owned foreign subsidiary (third tier). Brother-sister corporations are those controlled by a common parent, which may be either the domestic parent or one of its foreign tiers.
2. Eustice, *Tax Problems Between Affiliated or Controlled Corporations*, 23 TAX L. REV. 451–52 (1968).

conducting foreign business through foreign multiple incorporation is designed to maximize similar advantages of the corporate form under foreign law and to capitalize upon both United States and foreign tax preferences. Prior to 1962[3] our tax laws had the effect of encouraging accumulation and reinvestment abroad of foreign source earnings by a domestic company's foreign subsidiaries, since its earnings were taxable only upon actual repatriation.[4] Moreover, host country tax preferences and foreign tax credit allowances against repatriated earnings further accelerated the multiple foreign incorporation trend.

Historically, as a matter of United States tax policy, foreign corporations were immune from federal income tax, except with respect to their income earned in the United States. In contrast, domestic corporations were subject to federal income taxes on their entire earnings regardless of source. However, an evolution in tax policy has occurred over the years, resulting in the earnings of certain foreign corporations becoming taxable indirectly, so as to prevent tax avoidance through the use of foreign personal holding companies.[5] Conversely, the earnings of certain statutory domestic corporations are afforded tax preferences not heretofore available.[6]

This trend in tax policy has encouraged a second look by corporations before establishing traditional-type foreign sales subsidiaries and a look over the shoulder by those subsidiaries already established. However, the latter corporations must look through the tax consequences of § 367 of the Code before turning to an analysis of any significant tax savings to be derived by returning home.

In order to obtain repatriation non-recognition treatment for appreciated property transferred through an "up stream" corporate organization, reorganization, or liquidation between either the domestic parent or its domestic subsidiary and one of its foreign tiers, an Advance Ruling must be obtained from the Internal Revenue Service

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3. *See* note 14 *infra*.
4. In the early 1920's and during the post-World War II period through the early 1960's, tax haven legislation was enacted in an effort to encourage United States investment abroad. Yesterday's temporary need has become today's permanent fixture: (1) the China Trade Act Corporation (CTC) was created in 1922—a District of Columbia corporation engaged in business in China (Formosa and Taiwan, until recently), enjoying, among other special tax treatment, a complete deduction of all income sourced in China, if all of its stock is owned by U.S., Formosan or Hong Kong residents, INT. REV. CODE of 1954 [hereinafter cited as I.R.C.] §§ 931-33; (2) the Western Hemisphere Trade Corporation (WHTC) was created in 1942—a statutory domestic corporation currently affording a 14% tax savings against the corporate earnings tax, but no tax deferral at the shareholder dividend distribution level, I.R.C. § 992; (3) a United States' Possessions Corporation (PC), created under provisions enacted in 1950, permanently avoids corporate level taxes, and imposes a tax on dividend distributions only when actually paid, I.R.C. §§ 931-33; and (4) the Export Trade Corporation (ETC) was created in 1962 as an exception to the "tainted" income rules under Subpart F—further preserving the historical tax deferral treatment accorded non-distributed earnings of controlled foreign corporations, I.R.C. § 970.
5. I.R.C. §§ 551-58 (Foreign Personal Holding Company); I.R.C. § 951 (Subpart F income); I.R.C. §§ 864(c)(4), 882 ("effectively connected" rules).
6. *See* note 4 *supra*.

(the "Service") pursuant to § 367, certifying that the repatriation transfer does not have as one of its principal purposes the avoidance of federal income taxes. In addition, if a foreign subsidiary proposes to liquidate into its domestic parent corporation, Revenue Procedure 68-23 (guidelines establishing when a favorable § 367 Advance Ruling will be given by the Service) mandates that the parent obtain a favorable § 367 Advance Ruling prior to including as a dividend the subsidiary's share of the earnings and profits attributable to the domestic parent's stock. This is called a dividend toll ("toll charge") and has as its historical basis Revenue Ruling 63-6 and § 1248 of the Code,[7] and more currently Revenue Procedure 68-23, § 5.02.

Until recently, the toll charge presented a major obstacle for those companies desiring to repatriate foreign sales subsidiaries in order to obtain domestic tax advantages. However, recent experience has shown that the Domestic International Sales Corporation (DISC) can be an invaluable vehicle for easing the usual tax constrictions of § 367 in the repatriation of such foreign subsidiaries.

If the expatriation tax consequences imposed by the host country, as well as the non-tax considerations, do not preclude repatriation, the more favorable tax treatment available to the Export Trade Corporation (ETC) or the Controlled Foreign Sales Corporation (CFSC) as a DISC may be a significant factor in deciding whether to repatriate, particularly if the Service settles on a more liberal construction of its § 367 procedures. The tax savings which will potentially be available to the repatriating ETC or CFSC, in the usual case, are: (1) continued deferral of its pre-1963 and post-1962 Subpart F accumulations; (2) non-repatriation recognition of gain on the appreciated assets of the ETC or the CFSC; (3) complete transaction non-recognition; and (4) a substantially lower effective tax rate as a DISC.

THE DISC LEGISLATION

On December 10, 1971, President Nixon signed into law the Revenue Act of 1971 (the "Act"),[8] which included among its provisions a partial tax deferment mechanism called a Domestic International Sales Corporation (DISC) designed to encourage accelerated United States export trade and serve as one means of improving our balance-of-payments deficit.[9] Although a new corporate form, the underlying tax policy of reducing the tax advantages to foreign incorporation pre-dates the Nixon Administration. In 1961, President Kennedy proposed current taxation of all income earned by United States controlled

7. Eustice, *Affiliated Corporations Revisited*, 24 TAX L. REV. 101, 116 (1968).
8. I.R.C. §§ 991-97.
9. *See Hearings on H.R. 19047 Before Senate Comm. on Finance*, 92d Cong., 1st Sess., pt. 2, at 725 (1971).

corporations (except for those investing in less-developed countries).[10] President Kennedy's proposal was accepted only to the extent that its recommendations dissipated the foreign "tax haven" corporation extensively utilized by domestic companies as a purely tax savings device unrelated to any business purpose, with a modification which continued tax deferral for the ETC.[11]

All of these efforts since 1960 have been designed to improve our balance-of-payments deficit by curtailing the trend toward foreign incorporation through incentives aimed at encouraging domestic incorporation instead. Specifically, under the terms of the Act, DISC tax deferment became available for tax years ending after December 31, 1971.[12] This significant development represents a departure from the statutory policy of taxing *currently* profits earned by domestic corporations derived from foreign source income.[13] It was also heretofore possible to defer some of the tax on foreign source income if the domestic corporation established certain qualifying foreign subsidiary corporations.[14]

In summary, a DISC is a business, exporting certain consulting and leasing services or products, incorporated in one of the fifty states or the District of Columbia. If it is a subsidiary, it must have a separate bank account and separate accounting records, and elect DISC treatment[15] for tax years ending after December 31, 1971. In addition,

10. President's Tax Message, Apr. 20, 1961, H.R. Doc. No. 140.
11. H.R. REP. No. 1447, 87th Cong., 1st Sess. 47 (1961); S. REP. No. 1881, 87th Cong., 2d Sess. Part XII, Sub-Part B (1962).
12. Pub. L. No. 92-178, § 507, 85 Stat. 535 (1971).
13. Except as provided in I.R.C. §§ 951-64, and except those statutory corporations listed *supra* note 4.
14. Subpart G Export Trade Corporations. Historically, however, the United States generally taxed domestic corporations *currently* on all profits derived from export sales, while deferring taxes on the domestic parent's foreign subsidiaries until their profits were actually repatriated to the domestic stockholder. With the enactment of Subpart F in 1962, tax consequences are now precipitated through *constructive* dividend distributions to the domestic stockholder upon which a tax is levied *currently*. I.R.C. §§ 951-64.
15. DISC status must be affirmatively elected. The election must be filed within ninety days after the beginning of the DISC's taxable year. The content of the election statement is prescribed and must be signed by designated eligible officers of the DISC and provide such other information as required, together with the written consent to the election by each of the shareholders. Failure to file timely consent statements may be excused under certain circumstances, but it is otherwise a pre-condition to a proper DISC election. Detailed rules are established for consent statements where the stock has been transferred. In the usual case, the DISC will be a wholly owned subsidiary and obtaining the consent of all shareholders will not present a problem. However, where there are numerous shareholders, acquiring and filing timely consents may present formidable problems. Unlike the usual tax-option corporation, a DISC election is not inadvertently terminated. Although the DISC may fail to qualify for the DISC tax treatment at the end of the tax year in which the election is made, the election is still effective for subsequent tax years, unless the election is affirmatively withdrawn by the taxpayer or terminated by the Service. The election may be withdrawn by the taxpayer for any taxable year except the first, if the withdrawal is filed within the first ninety days of the DISC's tax year to which the withdrawal is intended to apply. Automatic termination by the Service occurs only where the DISC fails to qualify at the end of a tax year for five consecutive years, and this termination applies only to the sixth and succeeding tax years. Neither withdrawal of the election by the taxpayer nor auto-

it must meet the following qualifications: (1) have all of its shareholders consent in writing to the DISC election; (2) have a minimum of $2,500 of paid-in capital, par or stated value; (3) have outstanding only one class of stock; and (4) have, at the end of every tax year following its original election, a minimum of 95% of its assets (measured by adjusted basis) composed of qualified export assets,[16] and a minimum of 95% of its gross receipts composed of qualified export receipts.[17] If the DISC fails to meet either of the 95% assets or receipts tests, but it has "reasonable cause," it may make a deficiency distribution, plus interest, on the non-qualified receipts or assets and thereby avoid disqualification. "Reasonable cause" is presumed if the DISC had qualified export receipts of 70% continuously during the tax year.[18]

Once qualified as a DISC, the following special advantages are accorded: (1) avoidance of the corporate income tax; (2) avoidance of the minimum tax on preference items; (3) avoidance of the accumulated earnings tax; (4) avoidance of the usual double taxation effect on distributed corporate income; (5) only part of its net formula income is currently taxable; (6) the untaxed income is capable of indefinite tax

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matic termination by the Service prevents a subsequent new election. I.R.C. § 992(b); Rev. Proc. 72-12, § 1, 1972 CUM. BULL. 733; *id.* § 3.01, 1972 CUM. BULL. 734; *id.* § 4.03, 1972 CUM. BULL. 735.

16. Such assets include: (1) export property, such as inventory held for sale or lease abroad; (2) fixed assets related to its export business, such as an office building, office equipment, packaging and assembly equipment, a warehouse or other storage structure or storage equipment; (3) debt obligations accruing from its export transactions; (4) cash and securities needed for working capital requirements; (5) accounts receivable accruing from "producers loans" (loans to a domestic borrower, including the parent, taken from the DISC's tax deferred export income, where the borrower is engaged in the manufacture, production, extraction, or growing of export products); (6) securities in the following foreign affiliates: (a) a Foreign International Sales Corporation (FISC), which must itself meet the 95% export assets and export receipts tests, if the DISC owns more than 50% of the FISC's voting stock; (b) a foreign real estate holding corporation, where the property held is for the exclusive use of the DISC in its export business and in which the DISC owns more than 50% of the corporation's voting stock; and (c) an associated foreign corporation, provided the DISC, and any affiliated group to which the DISC belongs, does not own more than a 10% stock interest in the corporation and the corporation assists the DISC in the furtherance of its export business; (7) certain obligations issued, guaranteed, or insured by the Export-Import Bank or the Foreign Credit Insurance Association (FCIA); (8) obligations of a domestic corporation organized under agreement with the Export-Import Bank to finance sales of export property where the financing loans are guaranteed by the Export-Import Bank; and (9) tax year-end excess bank deposits of the DISC which are invested in qualified assets within a specified period of time. I.R.C. § 993(b)-(c).

17. The principal qualifying receipts are: (1) receipts from the sale of "export property;" and (2) receipts from the lease of "export property" to unrelated persons for use abroad. "Export property" is items produced, manufactured, extracted or grown in the fifty states or the District of Columbia by someone other than the DISC for direct use, consumption or disposition abroad. Finished product with more than 50% of its component parts purchased and produced outside the United States does not qualify as "export property." This percentage is tested by the fair market price of the imported content, at the time of importation, expressed as a percentage of the selling price put upon the finished product by the DISC. I.R.C. §§ 993(a)(1)(A)-(H), 993(c)(1)-(3), 993(c)(1)(C); Treas. Reg. § 1.993-3(e)(1)-(4) (1973).

18. I.R.C. § 992(e)(1)-(3).

deferment; (7) the untaxed income may be reinvested with the DISC, with certain qualified "related" or "unrelated" domestic or foreign corporations, or reinvested in certain qualified obligations or loaned to its parent, with certain limitations, without jeopardizing tax deferment; (8) allowance of liberal inter-company pricing rules offering profit attribution advantages between a parent and its wholly-owned DISC; (9) allowance of marginal costing; (10) liberal export promotion expense allowance; (11) shareholders are entitled to a credit against actual or "deemed" distributions from qualified export receipts in an amount equal to any foreign taxes paid by the DISC; and (12) the potential tax liability on its deferred tax income is not required to be accrued for financial accounting purposes.[19]

The DISC, as has been observed, is not subject to the corporate income tax (22% on the first $25,000 and 48% thereafter), but rather, half of its net formula income[20] is taxed *currently* as a dividend distribution to its shareholders, whether distributed or not. Tax on the remaining half is deferred unless it is actually or constructively distributed.[21]

Although the accumulated corporate earnings tax does not apply to a DISC, the Act applies accumulation concepts by establishing three segregated accounts: (I) accumulated DISC income; (II) previously taxed DISC income; and (III) other DISC earnings and profits which do not fall within (I) or (II). These accounts take on significance in understanding the distinction between *deemed* and *actual* distributions, on the one hand, and *constructive* distributions, on the other hand, resulting from triggering events which might precipitate *current* tax consequences to the DISC shareholder. Generally, *deemed* distributions, which accumulate in account (II) are earnings held by the DISC

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19. I.R.C. § 991; Treas. Reg. § 1.991-1(a)-(b) (1973); *see generally*, Note, *DISC—A Tax Incentive for Exporters*, 56 MINN. L. REV. 407 (1972).

20. Under the Act, pricing structure between the parent and DISC may be set so as to yield net income to the DISC which represents that portion of their combined income equal to 4% of the DISC's gross receipts plus 10% of the DISC's export promotion expenses, or which represents 50% of their combined net income plus 10% of the DISC's export promotion expenses. The liberal export promotion expense allowance will probably encourage parents to increase the promotion activities engaged in by its DISC rather than use the DISC as simply a paper handling conduit because the allowance is limited to the export promotion expenses actually incurred by the DISC. I.R.C. § 994(a), (c). If the 50% combined net income formula is employed to arrive at taxable income, the Act permits the use of marginal costing. Thus, if a DISC is seeking to maintain or establish a market for the parent's products abroad, it may use marginal costing in determining the combined net profit to be equally divided between the DISC and its parent, thereby enabling its products to be competitively priced in the foreign market. I.R.C. § 994(b)(2).

21. The tax saving derived from the use of a DISC is shown from the following comparative hypothetical. XYZ, Inc. is a domestic corporation which manufactures and sells "export property." It is not a member of a "controlled group," has no foreign affiliates, and is solely engaged in the manufacture of "qualified export products" which it thereafter sells to "unrelated" customers for their use abroad. It has annual gross income of $2,000,000 from the sale of its products; its cost of goods sold is $800,000; it spends $400,000 annually in promotion expenses related to the sale of its products, and has general administrative expenses of $80,000, all of which are associated with its export sales transactions. Its tax liability would approximate the following:

upon which *current* taxes have been paid. These earnings, when distributed, become tax-free dividends, or reduce taxable gain if the DISC stock is sold since these accumulations increase the basis of the DISC stock to the extent of this account. When there is an *actual* distribution of DISC income to the shareholder, the *deemed* distributions account, or account (II) (accumulated earnings upon which taxes have been paid *currently*), is debited to the extent of the *actual* distribution, resulting in a tax-free distribution. Only when this account is exhausted do *current* tax consequences follow an *actual* distribution. On the other hand, accumulations in account (I) earnings upon which tax has been deferred, will be *constructively* distributed, resulting in *current* tax consequences for the shareholder, whenever one of the following triggering events occur: (1) a loss of DISC status; (2) a loss of corporate status; or (3) a non-tax-free disposition of DISC stock. If any of these events are foreseeable consequences certain to occur to the business, DISC status may not bring the tax savings contemplated.[22]

Gross Income		\$2,000,000
Less:		
Cost of Goods Sold	\$800,000	
Section 162 Promotion Expenses	400,000	
Administrative Expenses all of which are attributable to Export Sales	80,000	1,280,000
Taxable Income		\$ 720,000
Normal Tax (22% × \$720,000)		\$ 158,400
Surtax (\$720,000 − 25,000 × 26%)		180,700
Total Tax		\$ 339,100

Assume that XYZ, Inc. establishes a wholly owned DISC, ABC, Inc., which assumes all of the promotion expenses and enters into a freight on board arrangement with unrelated customers abroad. The tax liability would approximate the following:

ABC, Inc. Gross Sales		\$2,000,000
Less:		
XYZ, Inc.'s Cost of Goods Sold to ABC, Inc.	\$800,000	
XYZ, Inc.'s Expense on Sales to ABC, Inc.	80,000	
ABC, Inc.'s Promotion Expenses	400,000	1,280,000
XYZ, Inc.'s & ABC, Inc.'s combined Before Tax Net Income		\$ 720,000
Less: Apportionment of Combined Net Income to ABC, Inc.		
50% of \$720,000	\$360,000	
10% of \$400,000	40,000	400,000
Apportionment of Combined Net Income to XYZ, Inc. (\$720,000 − 400,000)		\$ 320,000
XYZ, Inc. Tax on Apportioned Income		
Normal Tax (22% × \$320,000)	\$ 70,400	
Surtax (\$320,000 − 25,000 × 26%)	76,700	\$ 147,100
XYZ, Inc. Dividend Income from ABC, Inc. (50% of \$400,000 (ABC, Inc. Net Profit))	\$200,000	
XYZ, Inc. Tax on Dividend Income (48% × \$200,000)		96,000
XYZ, Inc. Total Current Tax		\$ 243,100
XYZ, Inc. Tax Without DISC		\$ 339,100
Less: XYZ, Inc. Tax with DISC		243,100
Current Tax Saving Using DISC		\$ 96,000

22. I.R.C. §§ 992(c), 995-96.

Despite the Treasury Department's view that the DISC legislation provides a "straightforward" and "simplified" method of affording tax saving incentives to domestically incorporated exporters,[23] it has been differently described elsewhere:

> In keeping with the high level of complexity one has come to expect as a matter of course in the foreign tax area, the DISC provisions quickly reach, and rarely leave, a plateau of statutory intricacy seldom rivaled in other sections of the Code; thus, the provisions easily qualify as a "four-star" example of Byzantine architecture in a statute not noted for its economy of line.[24]

Although more than 3,000 DISCs are known to have been established during the first two years of the Act's existence, many large export companies consider the potential problems an "awful nightmare," and small exporters believe compliance with the Act may be too costly because of its complexity.[25]

It is probably fair comment to say that the DISC legislation conforms to the general pattern of complexity necessitated by the nature of our "patchwork" method of enacting tax legislation. On the other hand, whether the DISC concept, as enacted, becomes either an "awful nightmare" or unnecessarily complex will, in large measure, depend upon the spirit with which the Service approaches its implementation through Regulations and Rulings.

REPATRIATION TAX CONSEQUENCES

The *current* tax savings[26] to be derived from the DISC may be an important factor in deciding whether repatriation-DISC-conversion is warranted for a particular ETC or CFSC. If not otherwise precluded from becoming a DISC,[27] repatriation through a DISC may offer a useful tax saving device, if the conclusion is otherwise reached that the comparative long term advantages, including tax advantages, between continued ETC or CFSC status and repatriation tilt toward the latter.[28] Before deciding to repatriate, the following other factors should be

23. U.S. Treasury Dep't, DISC—A Handbook for Exporters *i*, *l* (1972).
24. B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders S17-7 (3d ed. 1973 Supp., No. 1).
25. Fuller, *Many Doubt DISCs Will Boost Exports Sharply*, 314 J. Com. 1 (1972).
26. However, specific knowledge that a business, because of long range objectives or the occurrence of involuntary events, will undergo a corporate structural change may off-set this immediate tax advantage and these objectives and events should be considered for their future tax consequences before reaching the judgment that the DISC conclusively offers tax savings to a particular business, no matter what.
27. The following groups of corporations are ineligible for DISC status: (1) a corporation exempt under I.R.C. § 501; (2) a personal holding company (an exception applies in the case of certain subsidiaries of film makers); (3) banks, including savings institutions; (4) insurance companies; (5) regulated investment companies; (6) a China Trade Act Corporation; and (7) Subchapter S corporations. I.R.C. § 992(d)-(e).
28. The foreign tax impact must be carefully examined. Foreign tax preferences in the form of deferral of host country corporate taxes may trigger a current tax when expatriation occurs.

considered: (1) the cost of labor; (2) shipping costs; (3) foreign tax concessions; (4) non-tariff trade barriers; (5) host country expatriation taxes; (6) disruption to the foreign market established; (7) losses on the sale or exchange of property; and (8) the risk of tax policy reversals. One or more of these factors may outweigh the tax savings potential under the DISC.

The repatriation process itself may have significant *current* tax consequences. In the usual case, the foreign corporation considering repatriation is a first tier corporation having both pre-1963 and post-1962 accumulated Subpart F income and appreciated property, all of which would normally be taxable gain on repatriation to its corporate domestic parent in a manner prescribed by § 1248,[29] and under the "toll charge" Procedures of § 367. This section provides that gain shall be recognized in certain transactions unless it is established that the transaction does not have a tax avoidance purpose. As a condition to obtaining a favorable Advance Ruling with respect to certain transactions, the § 367 guidelines (Revenue Procedure 68-23) require the taxpayer (the domestic parent corporation) to agree to include certain recognized gain on repatriation as dividend income, commonly referred to as the § 367 "toll charge." The tax avoidance potential in repatriation transactions is limited to the repatriated earnings and profits of a foreign corporation transferred into the United States where such earnings and profits avoid current treatment as a dividend. Accordingly, the guidelines require these earnings and profits to be included in income at the time of the transaction or some later date.

Theoretically, but for Revenue Procedure 68-23, § 5.02, if a repatriation were structured as a § 332 liquidation,[30] and a favorable Advance Ruling from the Service were obtained under § 367, this structuring would avoid current income tax consequences on the gain.[31] However, because of Revenue Procedure 68-23, § 5.02, a current tax is imposed on repatriations notwithstanding § 332. Moreover, the Advance Ruling requirements of § 367 are mandatory. If the Advance Ruling is not obtained, the non-recognition accorded such transfers is not available, even where it can be conclusively shown that the Service would have issued a favorable Ruling. In *Construction Aggregates Corp. v. United States*,[32] where there was an "up stream" § 332 liquidation between *Construction's* controlled second and first tier foreign corporations, and where it was stipulated that the liquida-

29. In anticipation of the repatriation impact of I.R.C.§§ 951, 1248, controlled foreign corporations maintain the following separate accumulation accounts: (1) Pre-1963 earnings and profits upon which federal taxes have been deferred pending actual repatriation and Post-1962 Subpart F earnings and profits excepted from the *deemed* and *tainted* distribution provisions of § 951 upon which current federal taxes have been deferred pending actual repatriation; (2) Post-1962 Subpart F earnings and profits upon which federal taxes have been paid as a *deemed* distribution; (3) an asset account with a basis adjusted in accordance with § 1248; and (4) a *reinvested* account reflecting qualifying reinvestment income excluded from the *deemed* distribution provisions of Subpart F.

30. I.R.C. § 1248(d).

31. *See* I.R.C. § 332.

32. 350 F. Supp. 726 (N.D. Ill. 1972).

tion qualified for non-recognition,[33] the court held, among other things, that *Construction* forfeited the non-recognition benefits of § 332 because it failed to obtain an Advance Ruling from the Service under § 367.

It is not clear in the usual § 367 Ruling whether transfers of assets to a DISC resulting in tax *deferral*, as distinct from immediate or long range permanent tax *avoidance*,[34] offend the tax avoidance motive constrictions of § 367. Moreover, the Treasury Department has explicitly said, with respect to foreign sales affiliates incorporating as a DISC, that "the Internal Revenue Service generally will not consider that there is a United States tax avoidance motive for purposes of § 367."[35] The DISC may therefore be a useful device in avoiding current repatriation tax consequences.

REPATRIATING ETCS AND CFSCS

Subpart G[36] established a statutory controlled foreign sales corporation, the Export Trade Corporation (ETC), for balance-of-payments policy purposes identical to those underlying the DISC legislation. In fact, the DISC structure closely parallels the ETC structure.[37] By qualifying as an ETC, the foreign source income of a controlled foreign sales corporation could partially avoid the current tax impact of Subpart F.[38] However, the ETC tax saving was not a sufficient inducement to United States exporters,[39] and, therefore, relatively few were established. The DISC is intended to replace the ETCs which were established,[40] and the Act effectively repealed Subpart G with respect to

33. *See* Rev. Proc. 68-23, § 3.01(3), 1968-1 CUM. BULL. 822, not in effect at the time of the liquidation in *Construction*, which provides that in such situations a favorable § 367 Ruling will be issued, without regard to an eventual significant reduction in taxes. Under the 1971 amendment to § 367, "up stream" merger Rulings between first and second tiers may be obtained before or after the transaction. I.R.C. § 367(a) (2), (b) (1)-(2).

34. Rev. Proc. 68-23, § 5.02, 1968-1 CUM. BULL. 530, provides that the Service, in rendering a favorable Advance Ruling, will precondition such Ruling upon the agreement of the taxpayer to assent to a "toll charge" on the gain recognized on repatriation under § 1248. The Service says that this tax will be imposed in any case in which the failure to impose such tax may result in the *permanent avoidance* of the § 1248 tax in respect of post-1962 earnings and profits of the foreign corporation. Query: whether the tax deferral DISC provisions (to which the CFSC assets would be transferred in an "up stream" § 332 liquidation) are within the *may result in permanent avoidance* language of § 5.02.

35. U.S. TREASURY DEP'T, DISC—A HANDBOOK FOR EXPORTERS 32 (1972).

36. I.R.C. §§ 970-72.

37. *Compare* I.R.C. § 992 *with* § 971; *compare* § 993 *with* § 971(d).

38. Subpart F, enacted in 1962, in substance provides for the taxation of United States shareholders on foreign source income earned by a controlled foreign corporation, whether such income is distributed or not. I.R.C. §§ 951-64.

39. Additionally, the intricate legal and accounting requirements to obtain ETC status, and the constrictions of I.R.C. § 482 (inter-company pricing rules) when compared with the relatively small amount of income included in the deferral provisions, discouraged small and large exporters. *See* Hyde & Murphy, *DISC in Perspective and Operation*, 28 BUS. LAWYER 1, 49-50 (1972).

40. Pub. L. No. 92-178, § 505, 85 Stat. 551 (1971).

new corporations for tax years after October 31, 1971.[41] Section 505 of the Act permits the conversion of an ETC to a DISC, prior to the tax year beginning in 1976 in a non-recognition transfer, if the amount transferred is not less than the ETC's deferred Subpart F income, without the necessity of obtaining an Advance Ruling from the Service under § 367.[42] Moreover, the transfer may occur indirectly; that is, the parent may first receive the assets of its ETC and immediately thereafter, in an incorporation transfer, establish the DISC with the former ETC's assets, provided that the indirect transfer was carried out for a bona fide business reason and each United States person who is a party to the transfer enters into a closing agreement under § 7121.[43]

Properly structured, the conversion of an ETC to a DISC should avoid altogether or, at most, have minimum current tax consequences for the domestic parent. On the other hand, non-qualified ETC controlled foreign sales corporations (CFSCs) present more formidable structuring problems if a non-recognition repatriation to DISC status is to be achieved.

Unlike the ETC, the DISC Act did not expressly except the CFSC from the recognition provisions of § 1248. And the 1968 *Procedures* governing § 367 Rulings by the Service have not been amended since the DISC Act to reflect any relevant changes to the § 1248 dividend precondition to a favorable Ruling in an "up stream" § 332 CFSC repatriation.[44] However, as previously noted, the Treasury Department has said that the Service generally will not consider that there is a tax avoidance motive for purposes of § 367 in repatriating foreign sale affiliates.

Furthermore, the rationale underlying enactment of § 1248, as applied to repatriating foreign subsidiary corporations, was to avoid tax-free repatriations through the "exchange of stock" non-recognition provisions of the Code. These provisions had the effect of permanently avoiding tax following a non-recognition exchange between a first tier domestic corporation and its second tier foreign corporation because of the application of the dividend-received deduction allowance, thereafter available between the first tier transferee corporation and its parent under § 243.

Since the DISC Act expressly excludes DISC dividends from the dividend deduction allowance of § 243, where the DISC dividends are paid from the accumulated earnings account,[45] there would appear to be no reason for the Service to apply the § 1248 recognition provisions

41. I.R.C. § 971 (a) (3).
42. Additionally, the Service has advised to a non-recognition transfer where the parent makes a capital contribution to the ETC equal to the deficiency between the ETC's transferable assets and its untaxed Subpart F income, which would otherwise be recognized ordinary income under I.R.C. § 970(b), provided there are no liabilities assumed by the ETC and there is no consideration received by either the parent or the DISC in connection with the transfer. Rev. Rul. 73-196, 1973 INT. REV. BULL. NO. 17, at 28.
43. 1973 INT. REV. BULL. No. 16, at 24.
44. *See*, Rev. Proc. 68-23, § 5.02, 1968-1 CUM. BULL. 530.
45. I.R.C. § 246(d).

through the § 367 precondition ("toll charge") to a favorable Advance Ruling where the acquiring corporation in a § 332 liquidation is a DISC[46] and the acquired corporation is a foreign sales affiliate.

Permitting non-recognition repatriations under these circumstances would probably increase the incentive to the domestic parent to convert to the DISC, with a corresponding improvement in our balance-of-payments over the long run more than justifying the tax deferral treatment accorded. Moreover, it is possible for the Service to reach this result without additional legislation and without bending the Code in a way inconsistent with the purposes of §§ 332, 367 or 1248.

In addition to the recommended continued deferral of the CFSC's pre-1963 and post-1962 Subpart F earnings and profits, as transferred to the DISC accumulated earnings account, Revenue Procedure 68-23 should be amended to require as a condition to a favorable Advance Ruling: (1) that the domestic parent corporation make a capital contribution to the repatriating CFSC sufficient to extinguish any deficiency between its transferable assets and its pre-1963 and post-1962 Subpart F accumulations account; and (2) that it be shown to the satisfaction of the Commissioner or his delegate that there are no liabilities assumed by the CFSC and that no consideration will be received by either the parent or the DISC in connection with the repatriation. These additional requirements will result in conformity of treatment between repatriating ETCs and CFSCs.

CONCLUSION

Permitting the deferral of repatriation tax consequences, under the circumstances recommended here, simply implements the Congressional intent underlying the Revenue Act of 1971. The success of the tax policy, as expressed through the DISC concept, depends as much upon encouraging new domestic incorporation entries into the export trade as it does upon encouraging the repatriation of existing foreign selling affiliates. Both results will have the desired effect of improving our balance-of-payments deficit. In addition, utilizing the Ruling and Regulation authority to implement a desired tax policy is not a concept novel to the Service, particularly where the Congressional intent is so manifestly clear.

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46. *See* note 26 *supra* and accompanying text explaining the three DISC accounts. The repatriated Subpart F accumulations of the CFSC upon which taxes have not been paid would be allocated to the "accumulated DISC income account" upon which current taxes have been deferred. *See also* note 29 *supra*.