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Legislative Developments: The Abolishment of DISCs and the Creation of FSCs

Keywords

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I. INTRODUCTION

Congress created Domestic International Sales Corporations (DISCs) to encourage the export of certain United States goods. Recently, however, Congress largely abolished DISCs. In order to continue to encourage United States corporations to export products, Congress has created a new type of corporate tax entity, Foreign Sales Corporations (FSCs).

This article first describes DISCs. The article then discusses the DISC replacements that will continue to promote exports by both smaller and larger United States businesses. Specifically, this article will describe the three DISC replacements — the FSC, the small FSC, and the “interest charge” DISC. A final part explores some possible future developments in this area.

II. A DESCRIPTION OF DISCs

Legislation creating DISCs was enacted in 1971 to help alleviate United States trade deficits by promoting exports.¹ DISCs were to accomplish this goal by providing tax benefits to United States companies which exported certain domestic goods, called export property.² For DISC purposes, export property included property which was made, grown or extracted in the United States.³ Property not found to satisfy DISC purposes included patents, subsidized property, property found to be in short supply, and oil.⁴

A company could gain tax advantages through a DISC by strictly complying with complex laws describing how to create and operate a DISC. To qualify as a DISC, a company had to be incorporated under the

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1. Revenue Act of 1971, Pub. L. No. 92-178, 85 Stat. 497, 535-53, codified at 26 U.S.C. Sec. 991-97 (West 1982); *DISC Substitute Detailed In Administration Draft Proposals*, 20 TAX NOTES 240 (1983) (hereinafter cited as *DISC Substitute*)

2. Note, *Domestic International Sales Corporations (DISCs): How They Provide A Tax Incentive For Exports*, 14 VAND. L. REV. 535 (1981)[hereinafter cited as *Note, DISCs*].

3. 26 U.S.C. § 993(c)(1)(A); Nat'l Assoc. of Manufacturers, *Foreign Source Income: An Analysis of The Tax Reform Act of 1984* 2 (July, 1984)[hereinafter cited as *Foreign Source*].

4. 26 U.S.C. §§ 993(c)(2)(A), (B); *Foreign Source*, supra note 3, at 2.

laws of any state of the United States or the District of Columbia; issue only one class of stock, with a minimum par value of \$2500; elect to be treated as a DISC; and satisfy certain receipts tests.⁵

The usual arrangement worked as follows, Company A would create a subsidiary, Company B (the DISC). Company B would really amount to a "shell" corporation. A would control B and would be able to use B in such a way as to gain tax advantages on goods that A exported.⁶

Many DISCs were simple sales subsidiaries of the parent corporation.⁷ Most of these parent corporations were large manufacturing companies. These DISCs would receive the parent corporation's products and then transport and sell those products abroad.⁸ The parent corporation would set up these transactions in such a way so as to maximize the tax benefits to the parent corporation.⁹

The size of the tax benefit to the parent corporation depended upon the amount of export income that was allocated either to the DISC or the parent.¹⁰ DISC income was determined either by an "arm's length"¹¹ arrangement or under one of the two pricing rules for DISCs.¹² As long as the DISC properly complied with the arm's length pricing rules, the DISC could earn taxable income not exceeding the greater of:

a. Four percent of the qualified export receipts attributable to the sale of export property plus ten percent of the related export promotion expenses, which are the ordinary and necessary expenses incurred to obtain qualified export receipts; or

b. Fifty percent of the combined taxable income of the DISC and its related supplier attributable to qualified export receipts plus ten percent of the related export promotion expenses.¹³

The tax liability of the parent corporation for the DISC income that was distributed from the DISC was determined in the following way. The DISC's average gross receipts over a four year base period were com-

5. 26 U.S.C. §§ 992(a) 993(a), (b); See *Foreign Source*, *supra* note 3, at 3 and *DISC Substitute*, *supra* note 1, at 240 for a more detailed description of these requirements.

6. Comment, *DISC: A Continuing Problem*, 11 CASE W. RES. J. INT'L L. 623, 624 (1979)[hereinafter cited as *Comment*]. See also *DISCs*, *supra* note 2 at 540-42 for a lengthy description of the basic structure and operation of DISCs.

7. Comment, *supra* note 6, at 624.

8. *Id.* These DISCs being described were considered "buy-sell" DISCs. Another arrangement was to have DISCs sell abroad on a commission basis. The parent would transfer the product to the DISC according to the inter-company pricing rules established in 26 U.S.C. § 994(a).

9. *Id.*

10. Note, *Foreign Sales Corporation; A Viable Solution To The DISC Controversy*, 11 SYR. J. INT'L L. & COM. 47, 52 (1984) [hereinafter cited as *Foreign Sales*].

11. *Id.* at 52 n.31. "Arm's Length" is defined as the transfer prices established for specific transactions between two unrelated entities. This price is set at a price that would also be used by two related entities. See 26 U.S.C. § 482.

12. 26 U.S.C. § 994(a)(1) & (2).

13. *Id.*

puted. Then the excess of the current year's receipts over 67% of the average gross was determined.¹⁴ 57% of this excess was treated as distributed income and was fully taxable.¹⁵ The remaining 42% was retained by the DISC and was deferred from taxation.¹⁶

The tax benefits of a DISC had some interesting characteristics. First, the taxes on a DISC's income were deferred, not forgiven, on the portion of DISC profits from exports that were not deemed to be distributed.¹⁷ The amount of income deemed distributed to the parent corporation of its shareholders was subject to current taxation. In fact, the average amount subject to deferral for all DISCs was found to be about 17% of the combined taxable income of the DISC and its parent.¹⁸

Second, a company could perpetually defer paying taxes on the DISC proceeds by continually reinvesting the tax deferred income from the DISC into export-related activities.¹⁹ Most larger companies were successful in this objective and were continually deferring taxes on export proceeds. The smaller companies, however, by sometimes not fully complying with the complex DISC provisions, were occasionally required to pay the deferred taxes.²⁰ The cumulative effect was that little of these deferred taxes were ever recouped by the U.S. Treasury. The small amount of taxes that were recouped were often the result of mistakes by small businesses in not satisfactorily investing export proceeds into export-related activities.²¹

III. FOREIGN SALES CORPORATIONS

As a replacement to DISCs, Foreign Sales Corporations (FSCs) were created under the Tax Reform Act of 1984.²² DISCs have increasingly been challenged by the international community as being illegal under a treaty governing international trade issues, the General Agreement on Tariffs and Trade (GATT).²³ The United States, a party to the GATT,

14. 26 U.S.C. § 995(e)(3); See Note, *Foreign Sales*, *supra* note 10, at 53.

15. *DISC Substitute*, *supra* note 1, at 240.

16. 26 U.S.C. § 291(a)(4). The DISC legislation of 1971 was subsequently altered by legislation. For a discussion of these changes, see Note, *Foreign Sales*, *supra* note 10, at 53-54.

17. 26 U.S.C. § 995(b); *Disc Substitutes*, *supra* note 1, at 240.

18. *Foreign Source*, *supra* note 3, at 2-3.

19. *Of DISCs and FSCs*, 24 TAX NOTES 8 (1984).

20. Telephone interview with Leonard Santos, Professional Staff, Senate Finance Committee, September 2, 1984 [hereinafter cited as Santos].

21. *Id.*

22. Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, 1000-03; 26 U.S.C. § 805(a)(West Supp.1986).

23. General Agreement on Tariffs and Trade, *opened for signature* Oct. 30, 1947, 61 Stat. pt. 5 at A(11), T.I.A.S. No. 1700, 55 U.N.T.S. 194 [hereinafter cited as GATT]. The GATT is, *inter alia*, a multilateral treaty which governs the trading practices between countries. The GATT has regulated international trading since the end of World War II. The GATT has primarily addressed the lowering of tariff and non-tariff barriers to trade. See Note, *Foreign Sales*, *supra*, note 10, at 56.

decided to amend the DISC provisions in order to blunt the criticisms leveled against DISCs. The FSCs achieve roughly the same objectives as DISCs, yet they are specially designed to comply with the GATT.

A. *Reasons For the Repeal of DISCs*

Since their creation, DISCs have been opposed by the European Community (EC) and other signatories to the GATT.²⁴ These countries have contended that DISCs amount to illegal export subsidies, which violate the principles and the spirit of the GATT.²⁵ In 1973, before a Panel of signatories to the GATT, the EC filed a complaint against the United States for its use of DISCs.²⁶ Three years later, the GATT Panel found that the United States Government's failure to charge interest on the deferral of taxes constituted an illegal export subsidy.²⁷ The Panel also held that DISCs illegally allowed a permanent deferral of taxes in income derived from U.S. exports.²⁸

The GATT Council (the representatives of countries party to the GATT) accepted the Panel's report but also adopted an "Understanding" concerning export subsidies.²⁹ Specifically, the Understanding stated that: (1) a country did not have to tax economic processes located outside its territorial limits and (2) that an exporting company had to treat its related foreign buyers at arm's length for tax purposes.³⁰ Moreover, the Understanding permits countries to adopt measures to avoid the double taxation of income derived from foreign sources, which occurs when both the host and home countries levy taxes on the same income.³¹

The majority of the GATT Council, led by the EC member countries, urged the United States to bring the DISCs into conformity with the Panel's decision.³² Nevertheless, the United States continued to defend the legality of the DISC on the basis that the net effect of DISCs was permissible.³³ The United States argued that the effect of DISCs as an incentive to export redressed the tax export incentives of other countries inherent in their systems of taxation.³⁴

24. Foreign Sales Corporations, Senate Rep. No. 98-169, Vol. 1, 98th Cong. 630, 634 (1984)[hereinafter cited as Senate Hearings]; Note, *The GATT Qualifier: Its Validity As A Tax Standard And Its Effect on DISC and DISC Alternatives*, 16 CORNELL INT'L L. J. 469, 473 (1983) [hereinafter cited as Note,

25. *Senate Hearings*, supra note 24, at 634. See GATT, supra note 23, at Art. XVI:1.

26. Note, *The GATT*, supra note 24, at 473.

27. *Senate Hearings*, supra note 24, at 634; See also GATT: *DISC And Other Discriminatory Income Taxes*, 11 J.W.T.L. 564 (1977) for a thorough discussion of the Panel's findings.

28. *Senate Hearings*, supra note 24, at 634.

29. *DISC Substitutes*, supra note 1, at 241.

30. *Id.*; See also Note, *The GATT*, supra note 24, at 475.

31. *Id.*

32. *DISC Substitutes*, supra note 1, at 241.

33. *Id.*; See also Note, *The GATT*, supra note 24 at 478-86.

34. See *DISC Substitutes*, supra note 1, at 241.

In the GATT Council the EC member states in particular continued to insist that the United States should bring DISCs into conformity with the GATT.³⁵ These states went so far as to request the GATT Council to take retaliatory trade measures against the United States.³⁶ These harsh tones of the DISC debate, in the GATT Council, highlighted the bitterness of this dispute.³⁷

On October 1, 1982, the United States proposed legislation to remove DISCs as a contentious issue and to avoid the possibility of retaliation.³⁸ In March, 1983, the Administration approved and started to promote a proposal designed to replace the DISC with a simpler, territorial-based plan for the taxation of U.S. exports that would be legal under the GATT.³⁹

B. DISC Replacements

The Treasury Department and the United States Trade Representative developed a plan that would comply with the EC's objections to DISCs under the GATT while, at the same time, would continue to provide tax benefits similar to those offered to American exporters with DISCs. The result of these efforts was the Foreign Sales Corporation Act, (the Act) which took effect January 1, 1985. The Act generally repealed the DISC rules, and established new tax rules for the export of goods and services.⁴⁰ The Act did, however, retain the DISC rules subject to amendments for some small exporters; in addition, the Act forgave existing taxes on deferred taxable income from already existing DISCs. In essence,

35. *Id.*

36. *Id.*

37. *Senate Hearings, supra note 24, at 634.*

38. *DISC Substitutes, supra note 1, at 242.*

39. *Id.*; See *Dole, Rostenkowski Introduce DISC Replacement Bill*, 20 TAX NOTES 593, 595 (1983)[hereinafter cited as *Dole*].

40. *Virgin Islands, Guam Likely FSC Locations as Companies Await Treasury Department List*, INT'L TRADE REP. 257, 258 (1984); *Dole, supra note 39, at 595.*

The EC was somewhat skeptical of the FSC legislation. They objected strenuously to the exemption granted to the deferred income of the DISCs granted by the FSC legislation which treated the tax-deferred income of former DISCs as previously taxed income. The EC objected to this grant of several billion dollars of tax deferrals to the DISC shareholders. In fact, the EC has even threatened to challenge this procedure through GATT institutions. Text of DeMarche made to U.S. Trade Representative (Nov. 8, 1983)(available at the Headquarters of the European Economic Community in Washington D.C.) [hereinafter cited as *DeMarche*]. The EC has also asked for damages for the EC countries allegedly harmed as a result of the operation of the DISCs. Note, *Foreign Sales, supra note 10, at 62.*

The EC objected to certain characteristics of the territorial provisions of a GATT Understanding. See *infra* text and notes at notes 94-102. The EC charged that many of the actual substantive activities of the FSC would occur in the United States and not abroad as required by the Understanding.

The EC also charged that FSCs might encourage the use of tax haven jurisdictions by encouraging the flow of capital to those countries with a lower tax rate. This was felt to be undesirable in light of the stated policy of both the United States and the EC to discourage the use of tax havens. *DeMarche, supra.*

the Act establishes three new types of tax export assistance — FSCs (for large businesses), small FSCs, and “interest charge” DISCs (for small businesses and exporters).

1. *Provisions For Larger Businesses - The FSCs*

The FSC was designed to provide the same sort of DISC economic incentives to domestic companies to export goods. Beginning January 1, 1985, a larger company became able to obtain a permanent exemption from taxation on a portion of the export sales earned by the FSC.⁴¹

Generally, export goods which would have qualified for DISC treatment also began to receive beneficial tax consideration under FSCs.⁴² In addition, certain exports, such as particular types of depletable resources, also qualified under the new FSC rules.⁴³

Partial exemption is granted on the export income of a FSC when it meets two conditions: it must have an adequate foreign presence and, the economic and management processes of the transaction (which generate the income to be partially exempt) must occur outside the United States.⁴⁴ To meet the first condition of having an adequate foreign presence, FSCs must meet the following six requirements. The FSCs must: (1) be formed under the laws of: (a) any foreign country that has entered into an exchange of information agreement authorized under the Caribbean Basin Economic Recovery Act, (b) any foreign country that has an income tax treaty with the United States and has been found by the Secretary of the Treasury to carry out the necessary exchange of information requirements under the FSC legislation, or (c) any possession of the United States (e.g., Guam, the Virgin Islands, American Samoa or the Commonwealth of the Northern Mariana Islands);⁴⁵ (2) have no more than twenty-five shareholders at any time during the taxable year;⁴⁶ (3) not have any preferred stock outstanding during the taxable year;⁴⁷ (4) maintain an office outside the U.S. Customs territory at which the permanent books of account are maintained and keep tax records in the United States;⁴⁸ (5) have at least one director who is not a resident of the United

41. *Foreign Source*, *supra* note 3, at 5.

42. *Id.*

43. *Id.*

44. See 26 U.S.C. § 922(a)(1)(D).

45. 26 U.S.C. § 922(a)(1)(A)(i). See Dept. of Treasury News Release, *Treasury Department Issues Notice Regarding Certification of Exchange of Information Programs of Tax Treaty Partners for Purposes of the Foreign Sales Corporation Legislation*, (Nov. 6, 1984)(As of Nov. 6, 1984 the following countries had been certified for FSC purposes: Australia, Austria, Barbados, Belgium, Canada, Denmark, Egypt, Finland, France, Germany, Iceland, Jamaica, Korea, Malta, Morocco, the Netherlands, New Zealand, Norway, Pakistan, the Phillipines, South Africa, Sweden, and Trinidad and Tobago).

46. 26 U.S.C. § 922(a)(1)(B).

47. 26 U.S.C. § 922(a)(1)(C).

48. 26 U.S.C. § 922(a)(1)(D)(i)-(iii); 26 U.S.C. § 6001.

States;⁴⁹ and (6) be separate from any of the new "interest charge" DISCs.⁵⁰

To comply with the second condition, a FSC must meet the economic process test and certain management requirements. The FSC must solicit, negotiate or conclude the contract governing the transaction outside of the United States.⁵¹ In addition, one half of the costs incurred for publicity, handling orders, transportation, collection, and assumption of credit risk associated with a transaction must be incurred by the FSC, outside the United States.⁵² The economic process test is also important in governing the tax consequences of the transfer of goods between a FSC and its parent United States corporation.⁵³ The portion of the FSC's net export earnings attributable to its foreign economic processes can determine the tax liability of the parent.

The economic process requirements appear to differ from the DISC requirement since a DISC could be a paper corporation without conducting any real economic processes. Interestingly, though, the FSC is not required to become physically involved in the economic process requirements. Indeed, many of these services are being performed by agents hired by the FSC who are located abroad and who specifically perform these statutorily required economic processes. FSC management firms, which perform these required functions, have blossomed abroad since the enactment of the FSC legislation.

Finally, the FSC must meet certain management requirements. All shareholder and directors' meetings must be conducted outside the United States.⁵⁴ In addition, the FSC must maintain its principal bank

49. 26 U.S.C. § 922(a)(1)(E).

50. 26 U.S.C. § 922(a)(1)(F); *Foreign Source*, *supra* note 3, at 5.

51. 26 U.S.C. § 924(d)(1)(A); *Dole*, *supra* note 39, at 595. The IRS issued regulations which discuss what activities are included in the economic process test, explain how the tests are applied and provide for the verification of activities. Temp. Treas. Reg. § 1.924(d)-IT(c).

52. 26 U.S.C. § 924(d)(1)(B), 26 U.S.C. § 924(e); *Dole*, *supra* note 39, at 595. See also Temp. Treas. Reg. Sec. 1.924(d)-IT(d) for a more detailed description of these requirements. The 50% test is applied to all activities as a whole, *i.e.* the foreign direct costs do not need to total or exceed 50% for each activity. However, it is necessary that the FSC incur direct costs in at least three of the five areas. Temp. Treas. Reg. § 1.924(d)-IT(d)(5).

Moreover, there is an alternative 85% test that may be elected when the FSC's foreign direct costs attributable to any of the foreign direct economic processes equal or exceed 85% of the direct total costs attributable to such activities. 26 U.S.C. § 924(d)(2); Temp. Treas. Reg. § 1.924(d)-IT(6).

53. 26 U.S.C. § 925; *Foreign Source*, *supra*, note 3, at 9; *Dole*, *supra* note 39, at 595. These economic process requirements must be complied with or the FSC may be disqualified. See 26 U.S.C. § 925(c). These economic processes are evaluated on a case-by-case basis. See Temp. Treas. Reg. § 1.925(c)-IT.

54. 26 U.S.C. § 924(c)(1); Temp. Treas. Reg. § 1.924(c)-IT(b)(discussing which laws apply to various aspects of the meetings, where the meetings can be, etc. It is interesting to note that, according to these regulations, these meetings may take place anywhere outside of the United States and need not be conducted in the country or possession where the FSC is located).

account in a foreign country. All dividends, legal fees, accounting fees, and salaries must be paid from a foreign bank account.⁵⁵

The foregoing management requirements were specifically designed to satisfy the GATT. Interestingly, a FSC may maintain a shell bank account under the current regulations and fill up the account out of funds in the United States just prior to any disbursements. This fact has resulted in further EC criticism.

A properly structured FSC will qualify for a variable percentage of tax exemption with the non-exempt FSC export income being taxed at current corporate rates. The exempt portion may amount to as much as 74% or as little as 34% of the FSC's income depending upon the nature of the transaction.⁵⁶ The remainder of the export income is subject to U.S. taxes. In addition, all of the income earned by FSCs from investments is subject to taxation.⁵⁷

In sum, The FSC differs from the DISC in two important ways. First, the FSC must maintain a foreign presence and conduct a portion of its business outside the United States.⁵⁸ Second, the FSC grants an outright exemption from taxation, rather than an indefinite deferral, on a certain percentage of foreign income.⁵⁹

FSCs are designed to have the same general tax effect on United States exporters as DISCs.⁶⁰ The tax benefit gained by most large exporters would be approximately the same as their previous tax savings with DISCs. This result assumes, though, that these companies organize their FSCs in tax haven countries.

FSCs have, however, non-tax effects that differ from those of DISCs.⁶¹ First, many exporters will now establish sales subsidiaries

55. 26 U.S.C. §§ 924(c)(2) & (3). According to the Regulations, the bank in which the account is maintained may be a U.S. bank and may be readily accessible from within the United States. Temp. Treas. Reg. § 1.924c-ITc & d.

56. *Dole*, *supra* note 39, at 595; Kessler, *Legislative Update: Ring out the DISC - Ring In The FSC*, FED. BAR ASSOC. NEWSLETTER & SECTION ON INT'L L. 5 (AUG. 1984). See also *Foreign Source*, *supra* note 3, at 5-7 for a description of how to compute the tax for a FSC and how distributions are made by a FSC. In general, where the FSC income is subject to U.S. taxation, the income can be calculated in one of the following three ways: by an arm's length pricing method, the gross receipts method and the combined taxable income method. 26 U.S.C. §§ 925(a)(1), (2) & (3).

57. 26 U.S.C. § 921(d)(2); See also *Dole*, *supra* note 39, at 595. The rules treating these foreign trading receipts were modeled to some extent after the DISC rules on qualified export receipts. Essentially, qualifying receipts are those gains derived from the rule, exchange, or disposition of export property. 26 U.S.C. § 924(a)(1). Generally, qualifying export property is property manufactured, produced or grown in the United States by an entity other than a FSC for the use, consumption, or disposition outside of the United States. 26 U.S.C. § 927(a)(1)(A) & (B).

58. *CRS Analyzes Effect Of FSC Proposal on Export Firms*, 21 TAX NOTES 255, 255 (1983)[hereinafter cited as *CRS*].

59. *Id.*

60. *Id.*

61. *Id.* at 255-56.

outside the United States.⁶² It is likely that the FSCs will be incorporated in qualifying countries that impose little or no corporate tax.⁶³ In particular, corporations will generally incorporate their FSCs in countries that specialize in providing excellent financial services coupled with low corporate taxes in order to maximize the benefit of the tax exemption.⁶⁴

Second, the requirement of establishing a FSC abroad might actually dissuade some exporting companies from establishing FSCs.⁶⁵ The costs of establishing and maintaining foreign offices would undoubtedly reduce the profit margin of at least some of the businesses currently operating DISCs, thereby discouraging them from using the FSC provisions.⁶⁶ Most large businesses which took advantage of the DISC provisions have well established foreign subsidiaries; for these companies, establishing and maintaining a foreign presence might require little additional investment.⁶⁷

Finally, it has been argued that the incorporation of FSCs abroad could result in a transfer of some export related employment and activities from the United States to foreign countries.⁶⁸ It is apparent, however, that the economic processes that are required to be located abroad do not constitute a large portion of the employment involved in the production of United States exports.⁶⁹ Rather, the activities required to be located abroad generally relate only to sales — generally a small percentage of an exporting firm's employment.⁷⁰ In addition, many of the activities required to be conducted by FSCs are already being carried out by employees or foreigners abroad and would not result in any transfer of employment.⁷¹ Thus, employment in the export sector would appear not to be materially affected by FSCs.

2. Provisions For Smaller Businesses

The FSC Act provides two options for smaller exporters for whom the foreign presence and economic activity requirements might prove too burdensome.⁷² Both options do provide tax advantages for small exporters, although neither option is as advantageous to small businesses as the original DISC provisions.

62. *Id.*

63. *Id.* at 256.

64. *Id.*

65. 26 U.S.C. § 922; *CRS, supra* note 58, at 255-56.

66. *CRS, supra* note 58, at 255-56.

67. *Id.* at 256.

68. *Id.* at 255.

69. *Id.* at 256.

70. *Id.*

71. *Id.* at 257.

72. 26 U.S.C. § 927(f); *See Senate Hearings, supra* note 24, at 257.

(a) "Interest Charge" DISCs

Old DISCs can elect to become "interest charge" DISCs, and thereby avoid the costs of establishing or transferring export operations abroad.⁷³ A DISC with \$10 million or less of export income may choose to continue being an "interest charge" DISC.⁷⁴ With the exception of receipts for export sales of military hardware, almost all of the income generated by these DISCs is eligible for tax deferral.⁷⁵ An interest charge based on the treasury bill rate will, however, be levied on the deferred tax.⁷⁶ In addition, any of the qualified export receipts that unexpectedly exceed the \$10 million limit will be fully taxable.⁷⁷ The business can continue to qualify as an "interest charge" DISC despite exceeding the \$10 million threshold.⁷⁸

The benefit of being an "interest charge" DISC will vary from company to company.⁷⁹ Basically, it is a question of timing. The usual benefit of deferred taxes lies in the ability of a company to generate income from the deferred taxes. In other words, the company enjoys the benefit of being able to use the money for its own investment purposes for the period of the deferral, rather than immediately losing the money to the government.⁸⁰ Under the FSC Act, however, the interest charge assessed against the deferred tax liability would offset much of the income that the use of the deferred taxes would produce.⁸¹

Nonetheless, a firm can still benefit by using the "interest charge" DISC.⁸² For example, if a firm invests the deferred taxes wisely, it might receive a return that is greater than the interest charges.⁸³ Moreover, the parent company can deduct the interest charges, thus further lowering the actual cost of the charges.⁸⁴ Finally, a firm can avoid some of the interest charges by the selective timing of its payment of deferred taxes over short periods of time.⁸⁵

On balance, it appears that the tax benefits of "interest charge" DISCs are not as great as the advantages of the older DISCs. In addition, small firms could probably gain more advantages with small FSCs.

73. 26 U.S.C. § 802; *CRS*, *supra* note 58, at 257.

74. *DISC Substitute*, *supra* note 1, at 244.

75. *Id.*; *Senate Hearings*, *supra* note 24, at 658; *Foreign Source*, *supra* note 3, at 4.

76. 26 U.S.C. § 802; *DISC Substitute*, *supra* note 1, at 244, *Senate Hearings*, *supra* note 24, at 658.

77. 26 U.S.C. § 802; *DISC Substitute*, *supra*, note 1, at 244.

78. *Id.*

79. *CRS*, *supra* note 58, at 257.

80. *Id.*

81. *Id.*

82. *Id.*

83. *Id.* This may, however, prove difficult to do because of the high rate of return required to receive a rate of return higher than the interest charge.

84. *Id.*

85. *See id.* for a discussion of how a company can profit from the use of timing.

(b) *Small FSCs*

A small business can also elect to be a small FSC.⁸⁶ Unlike the large FSC, a small FSC need not satisfy the foreign presence and foreign economic process requirements to receive the same tax treatment as a large FSC.⁸⁷ Thus, the small FSC is similar to "interest charge" DISCs in that firms can avoid the onerous requirement of locating abroad.⁸⁸ Otherwise, the FSCs are still subject to the FSC operational rules — no exception is provided, for instance, regarding the pricing rules for goods transferred from a parent company to its small FSCs.

A firm would have to generate foreign trading gross receipts of \$5 million or less to qualify as a small FSC.⁸⁹ In the event of unforeseen excess receipts over \$5 million, these excess receipts would be subject to taxation.⁹⁰ In addition, a group of small FSCs which are connected to a larger parent company would all be treated as a single small FSC. There are regulations which prescribe how the \$5 million gross receipts limitation is to be allocated among the related small FSCs.⁹¹

Overall, it is apparent that the small FSC provisions will benefit small exporters, although the FSC provisions are more cumbersome and usually not as advantageous as the old small DISC provisions.⁹²

IV. FUTURE DEVELOPMENTS

The FSC is designed to accomplish legally, within the bounds of the GATT, what DISCs were charged with achieving in apparent contravention of the GATT. Nevertheless, the EC members do not consider FSCs to comply with the GATT, since FSCs have largely the same effects as DISCs. Moreover, replacing the DISC with the FSC has not necessarily dissuaded the Europeans from taking retaliatory measures against what they consider to be an illegal export subsidy.⁹³ It is quite possible that the Europeans could impose new countervailing duties against U.S. goods.⁹⁴ Indeed, Senator John Heinz (R. Pa.) has contended that Congress may be "substituting one kind of trouble for another kind of trouble."⁹⁵

86. 26 U.S.C. §§ 922(b)(1) & 927(f). The regulations discuss what is the effect of making an election as a small FSC, when a corporation can elect to be a small FSC, the termination of status as a small FSC, etc. Temp. Treas. Reg. § 1.927(f)-IT(a).

87. *Senate Hearings, supra* note 24, at 658. See 26 U.S.C. § 924(b)(2)(A); North and Feinschreiber, *From DISC to FSC*, 1 EXPORT TODAY 59, 61 (1985).

88. *But see Foreign Source, supra* note 3, at 9 (suggesting that a foreign presence is required).

89. *CRS, supra* note 58, at 257; *Foreign Sales, supra* note 3, at 658. See also, *Search for DISC Substitute To Be Taken Up By Congress*, 20 TAX NOTES 329 (1983).

90. 26 U.S.C. § 924(b)(2)(B)(i); *Disc Substitute, supra* note 1, at 244.

91. 26 U.S.C. §§ 924(b)(2)(B)(iii) & (iv).

92. *CRS, supra* note 59, at 257.

93. Bernick, *Administration Urges Passage of Foreign Sales Corporation Proposal*, 22 TAX NOTES 554, 555 (1984).

94. *Id.*

95. *Id.*

In addition, the Europeans are incensed over the fact that a tax debt of \$12 billion owed by United States exporters using DISCs was forgiven at the end of 1984.⁹⁶ What they fail to realize, however, is that the corporations owing these taxes would probably not have paid them anyway. Instead, these corporations would have invested the DISC proceeds into export related activities, thereby continually deferring payment of these taxes.⁹⁷ Moreover, it is not uncommon for taxes to be forgiven in these circumstances. Forgiveness is a common tax remedy when tax laws (such as the ones creating DISCs) are repealed.⁹⁸

The EC members have objected to the fact that the corporations now gain the benefit of being able to use the forgiven taxes in whatever fashion they desire. Since there was no limitation on the use by companies of this \$12 billion, these companies gained a windfall in the unrestricted use of the DISC proceeds.⁹⁹ Thus, EC member countries assert that, in fact, DISCs permitted a permanent write-off. This bolsters their argument that DISCs were illegal export subsidies all along.¹⁰⁰ The EC has discussed complaining formally in the GATT Council about the legality of this permanent deferral.¹⁰¹

Recently, the EC members included the FSC as objectionable, in a list of U.S. unfair trade barriers presented to the U.S. Trade Representative Clayton Yeutter. Specifically, the EC members contended that the FSC law was an inadequate response by the United States to the GATT discussions relating to the DISC dispute.¹⁰²

Although politically popular in the United States, FSCs may not prove helpful to US exporters over the long run.¹⁰³ The exchange rate adjustments made on a long term basis account for this result. As a tax incentive increases exports, there is a greater demand abroad for the dollar to buy these exports. The greater demand for the dollar, in turn, drives the price of the dollar up in foreign exchange markets.¹⁰⁴ This more expensive dollar makes U.S. exports more expensive for foreign buyers and foreign imports cheaper for U.S. consumers. Thus, the initial increase in U.S. exports erodes while imports to the United States increase.¹⁰⁵ It has even been concluded that "possibly the entire balance of payments effects of the FSC provisions would . . . be neutralized."¹⁰⁶ Once this economic possibility is realized, despite the FSCs domestic pop-

96. *Of DISCs and FSCs, supra* note 19, at 8.

97. *See id.* This assumes that such a likely alternative would have been included in the FSC legislation.

98. Santos, *supra* note 20.

99. *Id.*

100. *Of DISCs and FSCs, supra* note 11, at 9.

101. *Id.*; Demarche, *supra* note 40.

102. 3 INT'L TRADE REP. (BNA) 50 (Jan. 8, 1986).

103. CRS, *supra* note 59, at 255.

104. *Id.*

105. *Id.*

106. *Id.*

ularity, the legislators may eliminate the FSC provisions.

V. CONCLUSION

The creation of DISC substitutes constitutes an attempt to dress up the seemingly illegal DISCs in legal clothes. FSCs, small FSCs, and "interest charge" DISCs are all designed to satisfy the objections, of the EC member countries, to the DISCs lack of compliance under the GATT. Nonetheless, these DISC substitutes have not stemmed the criticism by the EC. There will undoubtedly be future developments in this politically sensitive area.

