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The Continuing Viability of the Banking and Financial DISC: A Tool for Sheltering Export Finance Income

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COMMENTS

THE CONTINUING VIABILITY OF THE BANKING AND FINANCIAL DISC: A TOOL FOR SHELTERING EXPORT FINANCE INCOME

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I. INTRODUCTION

In an effort to increase exports, the United States Congress in 1971 created the Domestic International Sales Corporation¹ (DISC) through use of a tax incentive program.² The DISC proved very popular. As a result of complaints from European members of the General Agreement on Tariffs and Trade (GATT),³ certain provisions of the Internal Revenue Code (IRC) were changed in 1984,⁴ creating Foreign Sales Corporations (FSC).⁵ The new entities established by these rules substantially replaced the use of the DISC,⁶ however, certain DISC provisions remain a part of the IRC,⁷ albeit in a revised form. The use of a DISC by large manufacturers is presently impractical due to a cap on revenue. This has created a perception that the DISC is dead.

As the DISC legislation stands, the DISC tax incentives are still very much alive despite the advent of the FSC. The DISC remains an effective tool for deferring taxes on up to \$10 million per year of income generated from export transactions. On their face, I.R.S. regulations prohibit financial institutions from being a DISC. They do, however, permit subsidiaries of a financial institution from attaining DISC status.⁸ The DISC can thus become a shelter for income and fees generated by export financing, and the deferred taxes can be considered as capital when computing a financial institution's primary capital.⁹

1. See generally I.R.C. §§ 991-997 (1996).

2. Cichanowicz, *Foreign Sales Corporations: A Viable solution to the DISC Controversy?*, 11 SYRACUSE J. INT'L L. & COM. 47 (1984).

3. *The Making of a Subsidy, 1984: The Tax and International Trade Implications of the Foreign Sales Corporation Legislation*, 38 STAN. L. REV. 1327 at 1327 (1986).

4. *Id.*

5. See generally I.R.C. §§ 921-927 (1996).

6. IRS Publication 953.

7. See generally I.R.C. §§ 991-997 (1996).

8. *Id.* § 992(d)(3) (1993). See also Rev. Rul. 73-247 (allowing a corporation ineligible for DISC status to be 100% shareholder of DISC corporation).

9. The portion of the earnings of a Domestic International Sales Corporation (DISC) that is eligible for tax deferral will accrue no income taxes to the parent company if sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely. ACCOUNTING STANDARDS AS OF JUNE 1, 1994: CURRENT TEXT, Statement of Financial Accounting No. 23 (Fin. Accounting Standards Bd. 1994).

Part II of this Comment traces the history of the DISC from its inception in the 1970s. Part III explains the legislative changes to the DISC which resulted from the challenges made by the European members of GATT, including the creation of FSCs. Parts IV and V examine the application of the current provisions of the DISC today. In short, this Comment deals with the value of a DISC subsidiary as a tool for financial institutions and the resulting advantage to be gained in primary capital computations. A short overview of export financing is provided to complement the presentation of the concept.

II. HISTORY OF THE DISC LEGISLATION

As early as the 1970s, Congress recognized the problem of deficit in the balance of payments,¹⁰ and that other countries were allowing exporters to reduce their income taxes.¹¹ As a result, the United States legislature created the DISC in the Revenue Act of 1971.¹² Through tax incentives provided by the DISC mechanism, this legislation sought to increase the level of total exports and thus reduce the deficit in the balance of payments.¹³ The DISC provision is a tax break for exporters with the deferral of taxes working as the incentive. This deferral can be maintained for as long as the funds are invested in qualified export assets.¹⁴

10. The balance of payments is a record of the value of all transactions between domestic and foreign residents over a given period of time, usually one year. It is based on the rule of double entry bookkeeping. In principle, the value of every transaction is recorded as both a credit and a debit. The purchase or import of anything from a foreign resident is recorded as a debit or minus entry in the balance of payments, while the sale or export of anything to a foreign resident is recorded as a plus or a credit item. JOHN E. PIPPENGER, *FUNDAMENTALS OF INTERNATIONAL FINANCE* 36 (1984).

11. ROBERT E. HUDEC, *ENFORCING INTERNATIONAL TRADE LAW: THE EVOLUTION OF THE MODERN GATT LEGAL SYSTEM* 62 (1993).

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

13. The Report of the Senate Finance Committee to accompany the Revenue Act of 1971 noted a trend of decreasing surpluses in the balance of goods and services. S. Rep. No. 437, 92d Cong., 1st Sess. 7 (1971).

14. A qualified export asset is:

- (1) export property (generally defined as property manufactured, produced, grown or extracted in the U.S. with not more than 50% of the fair market value attributable to articles imported into the U.S. and held for sale or lease in the ordinary course of business);
- (2) assets used primarily in connection with the sale, lease, rental, storage, handling, transportation, packaging, assembly, or servicing of export

A manufacturer that defers \$100,000 of taxes through the operation of a DISC can invest these funds in other inventory held for export. By reinvesting the money represented by the deferred taxes into other DISC authorized financial assets (i.e. Eximbank loans),¹⁵ a financial institution can maintain perpetual tax deferred income. The sponsors of the DISC legislation hoped to increase American exports by: (1) enabling exporters to lower their prices due to the tax reduction; and (2) increasing profitability of exporting with the intention of drawing a greater number of American firms into the exportation field.¹⁶ Generally, economists agree that lower costs will result in either lower prices and increased competitiveness or higher profits and the entrance of more participants into the market.¹⁷

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 or another corporation which is a DISC and which is a member of a controlled group . . . ;
- (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 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 purpose 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 (other than reasonable working capital) 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 to acquire other export assets.

I.R.C. § 993(b) (1993). This discussion will concentrate on financial assets described as obligations issued, guaranteed, or insured in whole or in part by the Export-Import Bank of the United States (Eximbank) or the Foreign Credit Insurance Association (FCIA) as authorized under I.R.C. § 993(b)(7) (1996).

15. See *infra* part V.

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

17. Robert S. Rendell, *Use of a Domestic International Sales Corporation to Reduce Federal Income Tax on Export Earnings*, 11 SAN DIEGO L. REV. 138, 139 (1973).

Initially, a DISC could be a shell corporation created solely for handling the export sales of U.S. manufactured goods. The manufacturer would bill its export sales through its DISC affiliate and receive a deferral on taxes applicable to the income from those sales. Congress originally expected a DISC to operate with a minimum of substance.¹⁸ The regulations provided leeway, anticipating that a firm would organize a new affiliate and operate it as a paper company on a commission basis to handle exporting functions.¹⁹

To qualify as a DISC, a firm incorporated under the laws of any U.S. state is required to comply with the following conditions:

- (1) ninety-five percent or more of its gross receipts must be "qualified export receipts."²⁰ These are specifically detailed in the Code and Regulations but, generally, are sales or income from sales by a DISC to a purchaser "for direct use, consumption or disposition outside the United States;"²¹
- (2) ninety-five percent of the assets must be "qualified export assets;"
- (3) the firm has only one class of stock and at least \$2,500 in capital;

18. Treas. Reg. § 1.992-1 (1995). I.R.C. Regulations specify that the DISC rules constitute a relaxation of corporate substance otherwise applicable under the code.

19. 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. See also Rendell, *supra* note 17, at 147.

20. I.R.C. § 993(a)(1) (1996). 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 lessee of such property outside the United States,
- (C) gross receipts for services which are related and subsidiary 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 (other than export property),
- (E) dividends (or amounts inclusive in gross income under section 951) 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 (or proposed for location) 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.

Id.

21. Treas. Reg. § 1.993-3(d) (1995).

- (4) the corporation has elected to be a DISC; and
- (5) the corporation is not a member of any controlled group of which a FSC is a member.²²

The DISCs proved popular and effective. Acceptance of the concept grew, and in March 1972, there were 1,136 DISCs.²³ By February 1981, there were 13,796 DISCs.²⁴ It has been estimated that in 1979 alone exports were increased by \$2.5 billion because of DISC legislation.²⁵ The popularity of DISCs had reached its peak when critics from outside the United States charged that DISCs were a violation of the GATT because their functional effect was to directly subsidize exports.²⁶

III. CHALLENGES TO THE DISC FROM THE GATT

The GATT²⁷ is essentially a series of multilateral trade concession agreements.²⁸ Signed by the United States in 1947, the GATT has become the central regulatory institution for the majority of world trade.²⁹ Article XVI of the GATT specifically prohibits export subsidies of non-agricultural products because they can affect international trade.³⁰ Any direct or indirect sub-

22. As defined in *id.* § 1.993-1(k).

23. David L. Boren, *Boren on DISC and GATT*, 16 TAX NOTES 271 (1982).

24. *Id.*

25. DEPT OF THE TREASURY, THE OPERATION AND EFFECT OF THE DOMESTIC INTERNATIONAL SALES CORPORATION LEGISLATION, 1979 ANNUAL REPORT 25 (1981).

26. Robert E. Hudec, *Reforming Gatt Adjudication Procedures: The Lessons of the DISC Case*, 72 MINN L. R. 1443, 1443-44 (1988).

27. GATT is now the World Trade Organization (WTO). The establishment of the WTO as a result of the Uruguay Round (GATT 94) incorporated into and made binding on the members all prior GATT agreements and legal instruments. Only four agreements were optional: those concerning civil aircraft, government procurement, dairy products and bovine meat. Agreement Establishing World Trade Organization, Dec. 15, 1993, pt. II of Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, GATT Doc. MTN/FA, reprinted in 33 ILM 1, 13 (1994).

28. GATT SECRETARIAT, THE GENERAL AGREEMENT ON TARIFFS AND TRADE; WHAT GATT IS AND WHAT GATT DOES 3 (1974).

29. See John H. Jackson, *The Jurisprudence of International Trade: The DISC Case in GATT*, 72 AM. J. INT'L L. 747 (1978).

30. GATT Article XVI § A — Subsidies in General

1. If any contracting party grants or maintains any subsidy, including any form of income or price support, which operates directly or indirectly to increase exports of any product from, or to reduce imports into its territory, it shall notify the Contracting Parties in writing of the extent and nature of the subsidization, of the estimated effect of the subsidization on the quantity of the affected product or products imported

sity that results in the sale of a product for export at a lower price than is charged for a similar product in the domestic market violates the GATT.³¹

Once the DISC regulations were passed, European GATT members challenged the tax incentives as illegal subsidies;³² they argued that the DISC system produced unlimited deferral of taxes and constituted an exemption as there was no rule in the DISC legislation which prevented the deferral from being maintained indefinitely.³³ Further, no rule required that DISC profits be distributed, while the DISC legislation provided for several ways in which profits could be used without distribution.³⁴ Therefore, the system did not afford only a limited advantage, but rather a total tax exemption from direct federal corporation taxes for one-half of the profits of a DISC accruing from exports.³⁵

into or exported from its territory and of the circumstances making the subsidization necessary. In any case in which it is determined that serious prejudice to the interests of any other contracting party is caused or threatened by any such subsidization, the contracting party granting the subsidy shall, upon request, discuss with the other contracting party or parties concerned, or with the *Contracting Parties*, the possibility of limiting the subsidization.

Section B — Additional Provisions on Export Subsidies

2. The contracting parties recognize that the granting by a contracting party of a subsidy on the export of any product may have harmful effects for other contracting parties, both importing and exporting, may cause undue disturbance to their normal commercial interests, and may hinder the achievement of the objectives of this Agreement.

31. GATT Article XVI:4:

[C]ontracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market.

Although Article XVI:4 was then in force for only about seventeen developed countries, the United States was one of them. The drafting history of the Article is described in ALAN C. SWANN & JOHN F. MURPHY, *CASES AND MATERIALS ON THE REGULATION OF INTERNATIONAL BUSINESS AND ECONOMIC RELATIONS* 404 (1991).

32. REPORT OF THE PANEL, UNITED STATES TAX LEGISLATION, GENERAL AGREEMENT ON TARIFFS AND TRADE, BASIC INSTRUMENTS AND SELECTED DOCUMENTS (23d Supp.) 98 (1977) [hereinafter GATT Doc. L/4422].

33. *Id.*

34. By the DISC investing its profits in other "qualified export assets" a DISC could maintain its DISC status and invest the accumulated profits in other income producing export assets.

35. Kenneth Simon, *The Great DISC Controversy*, 2 B.U. J. TAX LAW 115, 124 (1984).

In 1976, a GATT panel established to study the DISCs³⁶ concluded that DISC benefits did not represent tax deferrals but instead constituted a subsidy.³⁷ The panel stated that the DISC legislation "conferred a tax benefit and this benefit was essentially related to exports."³⁸ The panel also found that since the benefit of DISC legislation, by its own terms, arose as a function of profits from exports, it should be regarded as an export subsidy.³⁹ In October, 1982, as part of an agreement with the GATT Council to avoid retaliation,⁴⁰ the United States made a commitment to formulate legislation that would address the concerns of the other GATT members.⁴¹

A. *The Foreign Sales Corporation*

The United States' solution to the DISC controversy was the Foreign Sales Act of 1983.⁴² This Act provided for the formation

36. The panel consisted of three diplomats from GATT delegations in Geneva and two professors of public finance, one from the London School of Economics and one from the University of Turin. Hudec, *supra* note 26, at 1464.

37. GATT DOC. L/4422 (Nov. 12, 1976) at 1 (Chair informed Council of Panel's Composition on Feb. 17, 1976) reprinted in GATT, BISD, (23d. Supp.) 98 (1977).

38. *Id.*

39. Simon, *supra* note 35, at 130.

40. For an interesting overview of subsidies and countervailing duties, see SWANN & MURPHY, *supra* note 31, at 398-400 (1991).

41. Letter from U.S. Treasury Secretary Donald T. Regan to the GATT Council, reprinted in 17 TAX NOTES 708 (1982). In the letter, Regan stated:

Over the past several years, the General Agreement on Tariffs and Trade (GATT) has undertaken a detailed examination of the provisions designed to promote exports through DISCs to determine if they are in conformity with the GATT rules governing export subsidies. Although the United States has vigorously defended DISC, a general consensus has developed among GATT member countries that the DISC is inconsistent with the GATT and that the United States should bring its tax practices into compliance with these rules. The view held by many of the GATT members that the United States is not abiding by GATT rules seriously compromises the ability of the United States to use GATT to defend its trade interests. Accordingly, the Administration believes that the United States should respect the GATT consensus and attempt to comply with it.

The Treasury Department is now examining various alternatives to the DISC. Any alternative must comply with GATT and promote sound economic policy. A specific legislative proposal will be developed in the context of the fiscal year 1984 budget process.

Id.

42. The Foreign Sales Corporation Act of 1983 was originally introduced in the House by representatives Rostenkowski and Conable on August 4, 1983. See H.R. REP. NO. 3810, 98th Cong., 1st Sess. (1983). An identical Senate bill was introduced

of Foreign Sales Corporations. The FSC legislation honored the U.S. commitment to revamp DISC legislation and substantially replaced the existing DISC provisions. The DISC provisions, however, were not dropped from the code, but were retained with modifications through an "interest-charge" DISC.⁴³

An FSC, like a DISC, is entitled to U.S. tax benefits on export sales of the U.S. producer. In contrast to a DISC, however, an FSC must be a foreign corporation. Additionally, unless it is a small FSC with export sales of \$5 million or less, a corporation must meet complex foreign management and economic process tests.⁴⁴

The FSC will meet the foreign management requirement if it performs all three of the following functions:

- (1) it holds all board of directors meetings outside the United States;
- (2) it maintains its principal bank account outside the United States at all times during the taxable year; and
- (3) it disburses all dividends, legal and accounting fees, and salaries of officers and directors from a bank account outside the United States.⁴⁵

There are two elements to the foreign economic process requirement that must be met. First, the FSC or its agent must participate outside the U.S. in either the solicitation (other than advertising), the negotiation, or the making of the contract relating to an export transaction.⁴⁶ Second, the "foreign direct costs"

the same day by Senator Robert Dole. S. REP. NO. 1804, 98th Cong., 1st Sess. (1983). Neither version received consideration during the 98th Congress 1st session. On March 21, 1984, however, FSC was reported out of the Senate Committee on Finance as part of the Deficit Reduction Act of 1984, H.R. 4170. *See Summary of Deficit Reduction Act of 1984, reprinted in 23 TAX NOTES 178* (1984). Although not made part of the House tax act, FSC legislation was passed by the Senate in May of 1984. 130 *Cong. Rec.* S5973 (daily ed. May 17, 1984). In conference, both Senate and House conferees adopted the FSC bill on Saturday, June 23, 1984. The Conference Report was passed by both houses on June 27, 1984. 130 *Cong. Rec.* D902, D905 (daily ed. June 27, 1984). President Reagan signed the tax bill into law on July 18, 1984. 20 *Weekly Comp. Pres. Doc.* 1037 (July 23, 1984).

43. I.R.C. §§ 991-994 (1996). The new DISC provisions require DISC shareholders to pay interest on the amount of taxes deferred, thus "interest-charge DISC."

44. *Tax Relief for Exporters: DISC vs. FSC*, J. COM., June 9, 1989.

45. Linda Stillabower, Julian G. Buck & James D. Cigler, *Foreign Sales Corporations: The DISC Replacement*, 15 *TAX ADVISER* 710, 715 (1984).

46. I.R.C. § 924 (1996).

incurred by the FSC attributable to the transaction must be at least fifty percent of the "total direct costs" incurred by that corporation attributable to the transaction.⁴⁷ The FSC may qualify under this category if, of the "total direct costs" incurred, at least eighty-five percent of the direct costs associated with each of any two of the five designated categories are incurred abroad.⁴⁸

A corporate-owned FSC would exempt fifteen percent of its export income from the U.S. corporate tax.⁴⁹ The FSC's income may be repatriated to the U.S. corporate parent tax-free, while dividends to non-corporate shareholders would be subject to the recipient's normal rate.⁵⁰

IV. THE DISC TODAY

The DISC replacement legislation allowed a new or existing DISC to be maintained. Earnings of a DISC are totally exempt from U.S. taxes,⁵¹ but qualified export receipts are limited to \$10 million per year.⁵² A deductible interest charge was also imposed on DISC shareholders based on their deferred tax liability with respect to earnings retained by the DISC.⁵³ Interest is charged at an incentive U.S. Treasury Bill rate which is normally two to three percent under prime.⁵⁴ The obvious advantage of the DISC over an FSC is that the DISC can be operated as a "paper" subsidiary of a domestic corporation, without the

47. *Id.* § 924(d)(1)(B).

48. The five categories of direct costs comprising this test are:

- (1) Advertising and sales promotion.
- (2) Processing of customer orders and arranging for delivery of export property.
- (3) Transportation from the time of acquisition by the FSC.
- (4) Determination and transmittal of a final invoice or statement of account and the receipt of payment (billing and collection).
- (5) Assumption of credit risk.

See Stillabower, Buck & Cigler, *supra* note 45, at 11.

49. *Tax Relief for Exporters: DISC vs. FSC*, *supra* note 44. The tax rate would be sixteen percent if not corporate owned.

50. *Id.*

51. I.R.C. § 991 (1996).

52. Qualified export receipts in excess of \$10 million would be deemed distributed to the shareholders of the DISC. *Id.* § 995(b)(1)(E) (1996).

53. *Id.* § 995(f).

54. *Id.* § 995(f)(1)(B).

need to set up a foreign subsidiary.⁵⁵ There are practical and economic considerations which favor the use of a DISC in this regard. A DISC can earn, under U.S. Treasury safety rules, up to fifty percent of the U.S. producer's profit, plus ten percent of any DISC export promotion expenses.⁵⁶ The DISC itself need not render any services to earn such income.⁵⁷ The U.S. producer could continue to export products in its own name, issue invoices, and make all collections. At the end of the DISC's fiscal year, the U.S. producer would calculate its export profit and allocate fifty percent of that amount to the DISC.⁵⁸ If the DISC is a subsidiary of a U.S. corporation, generally one seventeenth of its income, plus all taxable income of the DISC attributable to export receipts in excess of \$10 million, would be constructively distributed to the parent corporation on the last day of the DISC's fiscal year.⁵⁹

The limitation of \$10 million in receipts has made the DISC unattractive for the large export manufacturer.⁶⁰ Of the changes concerning DISCs, the limit on export receipts to \$10 million most effectively curtailed the use of the DISC. The addition of an interest charge on the deferred DISC income does not substantially deter the utility of a DISC. The tax can still be deferred and the interest charge on the deferred income is at a reduced rate.⁶¹ More importantly, the interest paid is a tax deductible expense. The net effect is that the interest charge is also reduced from the parent's tax bill thereby making the effective interest rate even lower.

V. MODUS OPERANDI OF FINANCIAL DISCS

Current tax legislation prohibits a financial institution from structuring itself as a DISC. On the other hand, it does not

55. Rendell, *supra* note 17, at 147.

56. I.R.C. § 994(a)(2) (1996).

57. Treas. Reg. §§ 1.993-1(l), 1.994-1(a)(2) (1995).

58. *Id.* § 1.994-1(c)(3).

59. I.R.C. § 995(b)(1)(E), (F)(i) (1996).

60. Boeing, the aircraft manufacturer, had a DISC subsidiary that was active for booking sales of aircraft to the export market. The price of just one aircraft can easily exceed \$10 million, however, and the continued use of the DISC after the limitation of \$10 million is thus impossible.

61. As previously noted, the interest charged on the deferred income is the Treasury Bill Rate, usually two to three percent below prime.

prevent financial institutions from establishing a DISC subsidiary.⁶² Through such a subsidiary, a financial institution is able to receive all the benefits of DISC tax incentives. The subsidiary engages in its own export financing activities. Interest earned and gains recognized from these transactions constitute "qualified export receipts."⁶³ Consequently, DISC legislation defers the taxes on fifty percent of these gains.⁶⁴

A. *Qualified Export Receipts*

Once the financial institution establishes a DISC subsidiary,⁶⁵ either the parent corporation or the DISC itself must generate profits categorized as "qualified export receipts."⁶⁶ These profits come from a variety of income sources; however, the Eximbank⁶⁷ and the Foreign Credit Insurance Association

62. See I.R.C. § 992(d)(3) (1996).

63. *Id.* § 993(a)(1).

64. Treas. Reg. § 1.994-1(c)(3)(1995). Fifteen percent of corporate export profits of an FSC would be exempt from the U.S. corporate tax. A DISC, after distribution of one seventeenth of fifty percent of its corporate export profits, would shelter approximately forty-seven percent of these profits. Earnings from export profits exceeding \$10 million receive no shelter under the legislation. See *Tax Relief for Exporters: DISC vs. FSC*, *supra* note 44.

65. I.R.C. § 992(1) (1996).

66. *Id.* § 993(a)(1).

67. The Export-Import Bank of the United States operates today as an "independent agency" of the United States and acts under the authority of the statutory charter of the Export-Import Bank Act of 1945, as amended. Its origins, however, predate World War II back to the 1934 creation of two separate Export-Import Banks of Washington. This legislation came under the authority of the National Industrial Recovery Act, intended as a centerpiece of President Roosevelt's New Deal package of economic recovery reforms.

One of the banks was intended to provide export financing to the emergent Soviet market — a market characterized by high risk and a lack of convertible currency resulting in strong impediments to private sector financing. The second was originally intended for the single purpose of financing Cuban silver purchases for coinage. The two banks soon merged and, with encouragement from United States exporters, the single emergent bank expanded into a generalized agency for export financing to all world markets.

Today, the extension of loans is the most significant component of the Eximbank's financial support programs. The Eximbank generally undertakes the risks that commercial institutions are normally unwilling to assume. It takes these risks for the purpose of drawing private sector funds to export financing. The Eximbank often participates in loan transactions with commercial banks by funding longer maturities and "blending" higher commercial rates with its lower rates. The Bank also draws private sector funds to export financing through loan guarantees and insurance. Jordan J. Hillman, *Eximbank as a Public Enterprise: The Role of Congress and the Executive Branch*, 4 J. INT'L L. BUS. 374 (1982).

(FCIA)⁶⁸ are the safe and useful sources for generating income eligible for the DISC tax deferrals. These entities provide several different opportunities to realize such "qualified export receipts."⁶⁹ The following section is a general analysis of these options and their application to large, international financial institutions as well as those with more limited income generating capabilities.

A brief description of the Eximbank and the FCIA is useful background for the subsequent discussion.⁷⁰ The Eximbank is a wholly-owned U.S. Government corporation providing credit arrangements for the sale of U.S. goods and services abroad. The FCIA was created by a consortium of fifty-one private insurance companies and the Eximbank. The Eximbank later assumed full control of the FCIA when, in light of the international debt crisis of 1982, the private members withdrew their support. Eximbank and FCIA programs available to either an exporter or a United States bank provide credit protection against both commercial and political risks. These credit programs, discussed below, include direct loans, export credit guarantees and insurance, discount loan facilities, and obligations issued.

1. Direct Lending Program

The Eximbank's direct lending program extends long-term credits to foreign borrowers, supporting major transactions normally involving the acquisition of capital goods. The Eximbank prefers to operate through guarantees, leaving the funding of the loans to commercial banks. Direct lending is usually reserved for large projects where private lenders have evidenced no interest in participation.

As a way to induce private lender participation, there is a chapter under this program through which the commercial bank assumes the early maturities of the loan (i.e., the first two and a half years of a five year loan) and the Eximbank retains the longer maturities.

68. The Foreign Credit Insurance Association was created in a joint effort in 1961 by Eximbank and a group of fifty-one private insurance companies.

69. I.R.C. § 993(a)(1) (1996).

70. See generally William P. Streng, *DISC Qualified Assets — Obligations Issued, Guaranteed or Insured by Eximbank or FCIA*, 3 TAX ADVISER 394 (1972).

For a fee, the Eximbank will provide a financial guarantee to a commercial bank covering both commercial and political risks.⁷¹ This guarantee covers 100% of the principal and a substantial portion of the interest, making such direct lending relatively safe.

The direct loans become part of the Eximbank's own portfolio against which obligations are issued and placed on the investment market. Such riskless obligations constitute qualifying export receipts under the DISC legislation and may be purchased by any financial institution, regardless of its underwriting capability.

2. Export Credit Programs

While the Eximbank does not provide direct credits in short-term transactions, it does offer export credit support through a commercial bank, medium-term guarantee program as well as the FCIA insurance program.⁷²

71. Eximbank's financial guarantee covers political as well as commercial risk. The risk of default from political risk is due to:

- (1) cancellation of an import or export license;
- (2) war or other hostilities that occur in the buyer's country after shipment but before the due date;
- (3) expropriation;
- (4) confiscation of or intervention in the buyer's business; or
- (5) failure of the appropriate government authority to transfer the buyer's local currency deposit into United States dollars (transfer risk).

Any risk of default which is not a political risk is considered a commercial risk. Commercial losses are those effecting business regardless of location, such as a buyer's insolvency or failure to pay an obligation within six months after a due date (including failure to pay because of a currency devaluation). Disputes with the buyer, however, are not covered.

Eximbank covers 100% of the political risk, between 76.5% and 85% of the commercial risk, and up to 90% of the commercial loss coverage under FCIA insurance. Karen Hudes, *Protecting Against Inconvertibility and Transfer Risk: An Outline of Trade Financing Programs of the Export-Import Bank of the United States*, 9 HASTINGS INT'L & COMP. L. REV. 461 (1986).

72. FCIA offers both short term policies, covering credit payable in not more than six months, and medium-term policies, which cover installments and interest due on credit sales under terms ranging from six months to five years. AMERICAN BANKERS ASSOC., A BANKER'S GUIDE TO FINANCING EXPORTS (1963).

a. Commercial Bank Guarantees

In medium-term transactions (generally six months to five years), the bank guarantee program is available to an exporter through its commercial bank. The program allows the exporter to obtain both foreign receivable financing and risk protection by simply contacting its own bank. The bank then enters into a master guarantee agreement with the Eximbank, and the bank's own policies underwrite the export loans.

Under the medium-term guarantee program, a ten percent minimum cash payment must be made by the purchaser on or before delivery of the goods. The exporter must retain no less than ten percent of the financed portion for its own account and risk. Normally the commercial bank carries the commercial risk for the first half of the installments (but not exceeding eighteen months). Eximbank assumes all political risk and the remainder of the commercial risk.

The Eximbank's export sale loan guarantees may be issued directly to the DISC subsidiary, to its parent bank, or to an exporter. Normally the exporter obtains the Eximbank guarantee with the purpose of discounting the loan with a bank or financial institution.

b. Export Credit Insurance

Jointly administered by the Eximbank and the FCIA, the export credit insurance program extends credit protection to the U.S. exporter, which in turn provides its own credit to overseas customers.

The FCIA insurance protection is formalized through a Master Policy which covers the exporter's short-term (six months or less) export sales approved for coverage. Medium-term sales (six months or up to five years) are usually insured on a case-by-case basis, subject to specific policies. Those policies and related export documents are endorsed by the exporters to their banks to obtain financing.

The insurance may cover both commercial and political risks,⁷³ however, political risk may only be covered in sales to a subsidiary or when the exporter has full confidence in the credit performance of the foreign buyer, but wants to limit the coverage to the country risk to save on premiums. The underwriting capability requirements and risk quality of the FCIA insured obligations are similar to those applicable to Eximbank guaranteed notes; however, as with most insurance coverage, due compliance with FCIA policy terms is required in order to collect on any claims.

3. Discount Loan Facilities

Two discount facilities are available from the Eximbank. The first is a medium-term discount program, under which the Eximbank lends to commercial banks against export paper. This medium-term program has a maturity of one to five years, for up to 100% of the unpaid balance. The second discount program establishes short-term transactions requiring repayment in less than one year.

When the commercial bank is negotiating or considering an export credit, it can secure a binding commitment from the Eximbank to buy back the credit at a reduced price. This commitment ensures the bank's liquidity for the full term of the contract, hence reducing the amount of risk.

4. Direct Issue Debentures

The Eximbank is permitted to issue its debt obligations (debentures) directly to the public as a result of the Export Expansion Finance Act of 1971.⁷⁴ Although these debentures will not realize the same interest garnered by any of the alternate programs discussed above, they create a nearly risk-free investment directly into the Eximbank and qualify for the tax deferral under the DISC legislation.⁷⁵

73. See Hudes, *supra* note 71, at 464, 465.

74. Export Expansion Finance Act, Pub. L. No. 92-126, 85 Stat. 345 (1971).

75. I.R.C. § 993(b)(7) (1996).

B. Funding the DISC

Rather than generating export receipts directly through their DISC subsidiaries, banks and financial institutions can funnel qualifying export income from the parent institution to the DISC. Several alternative methods exist for channeling these receipts.

First, a bank or financial institution can feed such income to its subsidiary through the allocation of loan origination fees assessed on their export loans. The parent institution may allot such revenues in an amount complying with the DISC regulations.⁷⁶ The amounts transferred are usually large, without recourse, and require minimum bookkeeping entries, resulting in a procedure which is a relatively simple means of channeling revenue.

Second, the bank or financial institution may channel the interest and fee income of the export trade paper generated by the parent under the coverage of the Eximbank/FCIA insurance to the DISC.⁷⁷ Again, these are usually large transactions with limited bookkeeping and controlled payment delinquency, since the institution can promptly claim any past due paper through the credit insurance policies and guarantees of Eximbank/FCIA.

A third method of transferring income to the DISC subsidiary is through the assignment of proceeds of export loans guaranteed by foreign correspondent banks with good credit standing, rather than by either Eximbank or the FCIA.⁷⁸ While

76. Treas. Reg. §§ 1.993-1(d), (g) (1995).

77. *Id.* § 1.993-2(h).

78. *Id.* § 1.993-2(d), (h) and (i) apparently require that financial obligations of the purchaser have to be insured either in whole or in part by the FCIA or Eximbank or be trade receivables generated by the DISC itself or another member of the DISC's control group. It is incongruous that an otherwise qualified export financing program should be disqualified merely because it is not insured by the Eximbank. This export financing promotes U.S. export activity, thus fulfilling the purpose of the DISC legislation. Hence, shifting the credit risk to the foreign bank (through the use of the foreign bank guarantee) is a desirable result.

If the Internal Revenue Service requires that the Eximbank must insure the financing in order to qualify it as an export asset, a bank could still comply. The bank would take title to the goods through a trading subsidiary of the bank (meeting the control requirement for trade financing). The trading subsidiary would then transfer the trade paper to the related DISC subsidiary of the same bank. Although an additional step is required, the process will apparently bring the transaction within the guidelines of I.R.C. Regulation § 1.993-2(d).

there is a slightly increased level of risk compared to an insurance policy or guarantee through one of the aforementioned export agencies, the foreign banks have reliable credit and more than adequate funds and experience. These transactions also meet the desirable criteria for transfer to a DISC — large amounts that are easily accounted for in bulk transactions.

Emphasis has been placed on the size and ease of transfer of the projected income allocations. These parameters are essential, as the purpose of the DISC subsidiary is to minimize the tax burden on the parent company while avoiding the expense of a parallel bureaucracy between the parent and the DISC. The purpose of the DISC is to serve as a legal artifice, encouraging exporters and their financiers to expand foreign exchange generating activities. The potential red tape involved in elaborate and multiple transfers would only hamper its effectiveness.

A principal benefit from the use of DISCs in export financing is the accumulation of capital funds via tax deferrals on up to \$10 million of fifty percent of all qualified export receipts. Generally accepted accounting principles have acknowledged that because the deferred taxes on the qualified export receipts are in fact never paid, the deferral may be considered retained earnings for accounting purposes.⁷⁹ No liability deduction is

79. Undistributed Earnings of Subsidiaries — Provisions of APB Opinion No. 23:

Separate income tax returns are frequently filed for a parent corporation and its subsidiaries, particularly in the case of foreign subsidiaries. As a result, it becomes possible for income taxes to be incurred by the parent upon receipt of its subsidiary's earnings through the payment of dividends. APB Opinion No. 23 assumes that undistributed earnings of subsidiaries will be transferred eventually to the parent company and so directs that the latter provide for such additional income. If the parent includes such earnings in the consolidated income statement, income tax expense should be set up on such amounts in that period. Taxes accrued may be determined by assuming that all income of the subsidiaries was received in the period in which earned and that the parent also received the benefit of all available tax-planning alternatives, tax credits and deductions.

However, the presumption of such constructive receipt by the parent may be overcome, and no additional tax provision will be required if sufficient evidence exists that the unremitted subsidiary earnings will be reinvested indefinitely or that such earnings will be remitted later to the parent in a tax-free liquidation. History of the parent's policy of reinvestment of subsidiary's earnings and the existence of definite future programs are examples of the kind of evidence that may be required under APB No. 23. This substantiates the parent's intention of indefinite postponement of

made on the income statements for these deferred taxes, therefore increasing the capital worth of the institution.⁸⁰ The portion of DISC earnings which are not reinvested into exports, but rather are incorporated as part of the consolidated income of the parent, will not receive the tax deferral and must be accounted for as a liability. The increased capital is especially important in order to meet today's equity fund requirements.

Depending on which investment model is followed, revenue from the DISC would primarily consist of the interest charged on loans or the origination fee charged at the time of the loans inception. In order to generate revenue subject to \$10 million in taxes (the maximum tax deferral allowed),⁸¹ the bank or financial institution would necessarily be managing a substantial portfolio of loan transactions.⁸² While these amounts are far beyond the capabilities of a small institution, a large company could use DISCs to defer taxes on loan portfolios exceeding several hundred millions of dollars.⁸³

VI. CONCLUSION

The change in legislation in 1984 establishing the FSC may have curtailed the use of the DISC, but did not extinguish it altogether. Providing a way to channel funds away from the parent into a tax shelter, the DISC subsidiary is an extremely effective tool for banks and financial institutions in creating more capital and reinvestment. Whether through direct investment in export paper or by more indirect activities in the financial export field, the DISC subsidiary further promotes the sale of U.S. products abroad by increasing the availability of funds at a reduced cost to lenders, resulting in a more abundant funding market for export loans. A bank or financial institution can,

remittances from the subsidiary.

ALBERT P. AMEISS & NICHOLAS A. KARGAS, ACCOUNTANT'S DESK HANDBOOK 451 (6th ed. 1979).

80. Indeed this was the basis of the GATT complaint discussed in part III of this Comment. See Hudec, *supra* note 26.

81. I.R.C. § 995(b)(1)(E) (1996).

82. For example, current interest rates of under ten percent would require a loan portfolio of over \$100 million to meet the \$10 million cap. Alternatively, if the DISC only books the origination fees of international loans at a two percent fee, the institution could book \$500 million in loans annually.

83. See Hudec, *supra* note 26, at 1446.

through a DISC, effectively defer taxes indefinitely on fifty percent of its income, up to \$10 million, from the financing of exports. Additionally, in accordance with GAAP, reserves are not required for the deferred taxes. The deferred tax can then be included as primary capital for the computation of capital reserves for regulatory purposes in accordance with GAAP. Funds that would otherwise be paid as income taxes will be retained and reinvested to produce additional sheltered income.⁸⁴

Contrary to the traditionalist view, the DISC is not dead. If used as proposed above, the DISC can indeed shelter up to \$10 million of income that would otherwise be taxed. Through a novel application of DISC legislation, a financial institution can not only increase its own capital, but encourage reinvestment in foreign exports as well as expand the lending base for such activity.

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84. Retained earnings of a DISC can be reinvested in "qualified export assets" which include interest bearing obligations of the Eximbank and others as discussed above. Treas. Reg. § 1.993-2(h) (1995).

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