IC-DISC Audit Guide

LB&I-04-0212-003

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This Audit Guide is broken out into five sections:

Section I. - Introduction – Purpose, Format and Limitations

Section II. - General overview of the DISC.

Section III. - The DISC Law and Major Concepts, a Code and Regulation section approach to some of the major concepts of the DISC.

Section IV. - How Do I Start The Audit? - Suggested audit techniques.

Section V. – Selected Issues

1. **Introduction**

1. **Purpose**

1. This guide was developed to assist International Examiners in the audit of Form 1120 IC-DISC's.

2. **Format**

1. This document is prepared in an outline format. At various points, the outline includes rudimentary income statements and simple tax forms in order to explain certain concepts.

3. **Limitation**

1. This document does not contain every issue and/or case on this subject. You will always have to research for updates or for areas not covered in this guide because of newly identified issues, changes in law (code, regulations, cases and published guidance), or necessity of in-depth exploration of an issue.

2. As with all IRS texts, you cannot quote this material as the basis for an adjustment. However, the outline includes references to the IRC, regulations, cases, etc., which may be cited as the basis for your conclusion after you determine that the references you cite are still valid.
3. Finally this outline may include references to PLR's, TAM's and FSA's. These documents are included to help you understand a particular provision or statute. They are interpretations, or opinions, of certain persons in the National Office on a given issue relative to a particular taxpayer, THEY ARE NOT PRECEDENT FOR PROPOSING AN ADJUSTMENT.

2. **A General Overview of the DISC**

1. **Introduction to the DISC**

1. With the repeal of extra-territorial income exclusion ("ETI"), the Service began to see the re-emergence of the domestic international sales corporation ("DISC") in the form of an interest charge DISC ("IC-DISC").
2. The DISC provisions provide that the DISC, itself, is not subject to taxes imposed by subtitle A (Income Taxes). Instead the tax effect of transactions through a DISC, generally, would fall on the shareholders of the DISC.
3. There were two types of DISC contemplated:

1. A buy/sell DISC (one that actually took title to the goods it resold outside the U.S.); and
2. A commission DISC (one that is treated as if it were a commission agent for a principal who sold outside the U.S.).

1. The commission type DISC has historically been the more popular vehicle used for export sales.

3. It is possible a single DISC could accommodate both buy-sell transactions and commission transactions. However, taxpayers rarely, if ever, have used a single DISC for both types of transactions.
4. The DISC generally determined its income on a transaction by transaction (herein referred to as T by T) basis or if they so elected they could determine income on groups of transactions. Whether it used the T by T method or grouped their transactions the DISC's income is based on one of the following three pricing methods:

1. 4% of qualified export receipts ("QER") plus 10% of the DISC's export promotional expenses attributable to such receipts;
2. 50% of combined taxable income ("CTI") plus 10% of the DISC's export promotional expenses attributable to such income; or
3. Taxable income based upon the sale price actually charged but subject to the rules under IRC § 482.

5. These pricing methods provide caps on the DISC tax benefits. The taxpayer is not required to use the method producing the greatest tax benefit. The taxpayer is permitted

to claim tax benefits less than the amounts calculated using the 4% QER or 50% combined taxable income methods.

6. In addition to a choice of method, the DISC also had the option of determining income under each method on a full costing or a marginal costing approach.
7. In 1984, Congress modified the statutes and limited the impact of the DISC benefits.

1. The 1984 modification continued to provide for income deferral through the use of the DISC as a tax favored vehicle but only if the DISC shareholders paid an interest charge for the right to defer the income. This new DISC entity was therefore called an IC-DISC. Most of the IRC and regulations have not been amended to reflect this change, as such references to DISC should be read as IC-DISC.
2. Further, the modifications limited the benefits by way of a reduction in the amount that could be deferred. c) With these changes, all existing DISC elections were automatically terminated and any one wishing to continue doing business under the new IC-DISC vehicle would have to make a new DISC election.
3. The Service saw relatively few DISC tax returns between 1984 and 2006 because taxpayers preferred the FSC and later the ETI regimes, which generally produced larger tax benefits. Further, the FSC rules and the ETI rules denied double benefits under either provision to taxpayers that also had a DISC.

8. The American Jobs Creation Act of 2004 (“2004 Act”) repealed the ETI tax regime.
9. Now some 23+ years later with the repeal of FSC and ETI we are seeing the DISC return back in the audit stream in greater numbers. Starting with the 2007 year tax filing season DISC returns began to show up in our examinations. The latest filing numbers put the DISC filings above 2,000 returns filed for the 2008 tax year.

2. **How the DISC Return is Processed and Procedures for Requisitioning**

1. The DISC returns are filed with the Covington Kentucky Service Center.

1. IRC § 6091 and Treas. Reg. § 31.6091-1. Place for filing returns- Treas. Reg. § 31.6091-1(d) provides an exception to the general rule where a corporation return is to be filed. That exception provides that “**whenever instructions applicable to such returns provide that a return shall be filed with a service center such returns will be so filed in accordance with such instructions**”. The DISC return filing location is an exception since the Form 1120 IC-DISC instructions provides that all 1120 IC-DISC returns are to be filed at the Covington, Kentucky Campus.
2. Form 4876-A, Election to be Treated as a DISC, are filed with the Covington Service Center as well.

1. If a Form 4876-A or DISC return were to be inadvertently filed with another Service Center, the form may be transshipped to the Covington Service Center.

3. Once received by the Service Center, all Forms 1120 IC-DISC are first processed in the Covington Service Center’s Document Perfection (“Code & Edit”) section.

1. Code & Edit ensures that the Form 1120-IC-DISC is complete and determines if the corporation is an eligible DISC filer (approved Form 4876-A on file, etc., (IRM 3.11.16)).
2. Ineligible DISC returns are routed to Exam. Eligible DISC returns are numbered then they are processed through the Non-Master File Accounting Function (IRM 3.17.46) as a Non Master File ("MFT23") document.
3. After approximately 6 to 9 months the non-master file return ("NMF") accounting function sends the returns to "Files" where they are maintained for 2 years. After 2 years the returns are retired to the Federal Records Center.
4. All Forms 4876-A are sent to, and maintained by, the Service Center's Document Perfection Function.

1. The Form 4876-A is processed and stored in ALPHA order in Document Perfection- Code and Edit. At the time of the writing of this guide there were no procedures in place to retrieve Form 4876-A from this section.
5. The 1120 IC-DISC return is processed as a NMF (See IRM section 21.8.3.1.2). They are processed as MFT 23 - tax class 06.

1. The proper procedure to secure these returns is by means of a paper request which generally consists of submitting requests to Accounting via Form 2275, Record Request Charge and Recharge.
2. The forms should be sent to Cincinnati SPC, PO BOX 12267 Covington, KY 41012.

1. Form 2275 is used to request income tax returns, information related thereto, and other Service documents. It serves as a charge out and recharge record. If the returns requested are current year returns (in the last 6 months) they will be filed in automated non-master file accounting ("ANMF") unit, anything prior will be in the files area.
6. A request for a transcript can be accomplished with a FAX request sent to the Accounting Branch at the Cincinnati Service Center.

1. Requests for the printing & faxing of requested ANMF transcripts should be faxed to 859-669-2959.

1. You will need to supply the DISC's employee identification number ("EIN") and name.
7. A new ANMF system makes it even quicker and easier to research and order transcripts directly from a local computer terminal forgoing the older paper request system and the FAX requests. This new system is automated nationwide. ANMF is an independent database that does not interface with IDRS.

1. Access to the ANMF system may be obtained by requesting a LOGIN name and password for the ANMF system by completing the "On-Line Form 5081" process. See IRM 4.5.3.4.3.2.
2. The ANMF system allows you to read entities or transactions on the file by following the instructions displayed with the "Research NMF" option.

1. With the “Query” command, you can search for a desired entity by entering the DLN or TIN, MFT, and plan period of the desired record. If you have only partial information, enter the data for any field(s) shown on the screen, then page for the record you need.
2. Use the “NMF Transcript” option to request a printed transcript (not a certified transcript) that will be delivered from the NMF unit on the next day. The ANMF system does not provide the “print screen” capability that would allow you to copy what you see on the research screen.
8. For complete instructions for researching NMF, refer to IRM 3.17.46, Automated Non-Master File Accounting, or contact the NMF unit in the Accounting Branch.
9. All Form 1120-IC-DISC with no tax to be assessed and no evidence of a payment are processed on the index card system (“ICS”), and an account is not established on the database. A majority of the Form 1120-IC-DISC’s that the NMF unit receives are input to the ICS. Only the NMF unit has access to the ICS. The NMF Team would need to be contacted in order to receive a print of the transcript from the ICS.
10. If the Form 1120-IC-DISC is received with tax, and/or a payment an account on the ANMF database would be established. Anyone can research the ANMF database once they have received an ANMF Research group password. They also would be able to request transcript, place a history on the account which would include their fax number, and the NMF Team would fax the request directly to the requestor.
11. Recently we have had success getting AIMS control via Form 5354 Examination Request – Non-Master File.

1. Note - in the box marked Source Code use “50”
3. **Summary of the DISC Rules**

   Following this brief summary will be an in-depth analysis of the law relating to the DISC. That expanded analysis can be found in Section III.

1. IRC § 991 provides that a DISC is not subject to income taxes.

1. Treas. Reg. § 1.991-1(a) reaffirms the non-tax status of the DISC for income taxes.

1. The DISC, however will be liable for other taxes that a corporation may be held liable for, such as taxes withheld at the source, employment taxes, interest equalization taxes and excise taxes.
2. Prop. Treas. Reg. § 1.991-1(a) amended the original DISC regulation by adding the provision that for years after 1984 the shareholders of a DISC are required to pay an annual interest charge on the shareholders “DISC related deferred tax liability.”

1. The interest charge is imposed on the shareholder and not the DISC.
2. Treas. Reg. § 1.991-1(b) provides rules for determining the taxable income of the DISC, including methods of depreciation, inventory methods, the choice of accounting methods and the choice of the annual accounting period, etc.,

1. All such taxable income elections must be made by the DISC.
2. The 1120 IC-DISC return must be filed on or before the 15th day of the ninth month following the close of the DISC taxable year. [1]

1. There are no provisions available for an extension of time to file this return.

1. When filing its first tax return and all subsequent filings a DISC must use the same annual accounting period of its principal shareholder. [2]
2. IRC § 992(a) and Treas. Reg. § 1.992-1(a) provides that the term “DISC” means, with respect to any taxable year, a corporation which is incorporated under the laws of any State or the District of Columbia, and satisfies the following conditions for the taxable year:

1. 95 percent or more of the “gross receipts” (as defined in IRC § 993(f)) must consist of QER (as defined in IRC § 993(a));
2. The adjusted basis of the “qualified export assets” (as defined in IRC § 993(b)) of the corporation at the close of the taxable year must equal or exceed 95 percent of the sum of the adjusted basis of all assets of the corporation at the close of the taxable year;
3. The DISC must have only one class of stock and the par or stated value of its outstanding stock must be at least $2,500 on each day of the taxable year;
4. The corporation must have made an election to be treated as a DISC and that election must be in effect for the taxable year;

1. An election is made using Form 4876A
2. IRC § 992(b) and Temp. Treas. Reg. § 1.921-1T(b)(1) provide specific rules for when and where this election is to be filed.
3. All shareholders of the DISC must consent to the DISC election. Treas. Reg. § 1.992-2(b) provides rules for the proper filing of the consents.
4. Strict adherence to the timing rules for making the consents and the elections is a must.

1. Failure to make the election on time will result in the DISC not qualifying as a DISC and the loss of DISC benefits.
2. If taxpayer failed to make a timely election, please verify if taxpayer has requested or been granted relief for such late filing under Treas. Reg. §§ 301.9100-1 and 301.9100-3.
5. Treas. Reg. § 1.992-1(a) provides other conditions for the existence of a valid DISC and they are as follows:

1. The DISC must maintain a separate set of books and records;
2. The DISC must not be an ineligible corporation as defined in IRC § 992(d); and
3. The DISC must not be a member of any controlled group (defined in IRC § 993(a)(3)) of which an FSC or small FSC is a member.

1. This condition serves to prevent taxpayers from claiming benefits under both the FSC and DISC regimes.

2. Similarly, IRC § 943(h), provides that the taxpayer cannot benefit from the ETI under IRC § 114 if the taxpayer is in a controlled group with a DISC.
6. DISC is not concerned about performance of any activities and, therefore, does not need employees or office space and does not have to actually participate in the soliciting, negotiating or concluding of any sales contract or perform any economic functions to earn a commission.
7. On the surface the DISC appears to violate our general rules relating to corporate substance;
8. Treas. Reg. §1.992-1(a) explains that the rules of this section are intended to relax the rules of corporate substance otherwise applicable under the Code and when coupled with the DISC entitlement to income provision of Treas. Reg. § 1.993-1(l), constitutes a barrier to the IRS to applying IRC § 482
3. If a DISC has met the IRC § 992 requirements and made the proper elections and consents then it is treated as a non-taxable entity. IRC § 994 allows the DISC and the related supplier ("R-S"), the actual exporter, to determine the amount of the transfer price, or DISC commission, by its choice of one of three methods:

1. The 4 percent gross receipts plus 10% of the DISC export promotion expenses;
2. The 50-50 combined taxable income plus 10% of the DISC export promotion expenses; and
3. The § 482 method.

   Each of the methods above could be applied on a transaction by transaction basis separately for each transaction. The DISC could also elect to determine its transfer price using product or product line groups. [3]
4. Like FSC, the DISC also has a no loss rule when applying the available pricing methods. However, the mechanical application of the DISC no-loss rules is different than the FSC no loss rules and can lead to a different result.
5. There are some basic similarities between FSC and ETI and the DISC provisions – such as:

1. Definitions of export property;
2. Foreign content rules;
3. Destination tests and use tests;
4. Grouping rules;
5. Marginal costing rules.
6. There are also some differences between the FSC/ETI and DISC provisions:

1. Transactions that failed to qualify for FSC or ETI benefits only disqualified the transaction while under the DISC rules transactions that fail to qualify could potentially disqualify the entire DISC status.

2. FSC and ETI looked to specific selling activities and economic processes conducted outside the U.S. while DISC does not require these same activities or processes to take place.
3. The FSC and ETI provisions were applicable to foreign trading gross receipts from sales, leases and other dispositions as well as gross receipts from engineering, architectural and managerial services. DISC provisions are more expansive in that they also allow limited benefit for interest and dividends.
7. The income earned by the DISC is, generally, taxable to the shareholder in the form of a deemed distribution and an actual distribution.

1. **Deemed distribution** is defined in IRC § 995. The most common form of a deemed distribution is IRC § 995(b)(1) – Distributions in qualified years. During any year in which a corporation qualifies as a DISC, a deemed distribution is (limited to the E&P for the year) the DISC shareholders' pro rata share of the following items:

1. The gross interest derived during the year from producer's loans – (IRC § 995(b)(1)(A));
2. The gain recognized by the DISC during the taxable year on the sale or exchange of property, other than property which in the hands of the DISC is a qualified export asset, previously transferred to it in a transaction in which gain was not recognized in whole or in part but only to the extent that the transferor's gain on the previous transfer was not recognized - (IRC § 995(b)(1)(B));
3. The gain (other than the gain described above) recognized by the DISC during the taxable year on the sale or exchange of property which is a qualified export asset (but other than inventory) previously transferred to it in a transaction in which gain was not recognized in whole or in part but only to the extent that the transferor's gain on the previous transfer was not recognized and would have been treated as ordinary income if the property had been sold or exchanged rather than transferred to the DISC – (IRC § 995(b)(1)(C));
4. 50% of the taxable income of the DISC attributable to military property - (IRC § 995(b)(1)(D));
5. 100% of the taxable income attributable to QER of the DISC that **exceed** $10,000,000. – (IRC § 995(b)(1)(E));
6. Certain other amounts – (IRC § 995(b)(1)(F)).
7. The amount of foreign investment attributable to producer's loans of a DISC for a taxable year - (IRC § 995(b)(1)(G)).
2. There are also deemed distributions related to certain disqualifications – (IRC § 995(b)(2)).
3. Generally, the DISC's taxable income attributable to the first $10,000,000 of gross receipts from the sale or exchange of qualified export assets is not included as a deemed distribution and is therefore only taxable to the shareholder if the DISC actually distributes this amount to the shareholder. If the DISC does not choose to distribute this income pro rata to its shareholders then this becomes the base for "**deferred DISC income**." **See** IRC

§ 995(f)(3). This is the amount that will create a shareholder's **DISC related deferred tax liability** upon which the interest charge is determined.

4. A shareholders **DISC related deferred tax liability** is defined in IRC § 995(f) and in Treas. Reg. § 1.995(f)-1(d). Briefly, this is the difference in the shareholders income tax liability computed first with and then without including the deferred DISC income. Each year the shareholder must take into account the cumulative amount of the income tax that is considered to have been deferred. There are examples of this computation in the regulations at Treas. Reg. § 1.995(f)-1.
5. The **Form 8404** is used by shareholders of a DISC to compute and report the interest charge on DISC related deferred tax liability. The authority for this can be found in Treas. Reg. § 1.995(f). The instructions for form 8404 may provide an easier way to understand the rules. The relevant parts of those instructions are below. They read in part as follows:

   Who must file. You must file Form 8404 if:

   - you are a **shareholder of a DISC**;
   - the DISC reports **deferred DISC income** to you on line 10, Part III of Schedule K (Form 1120-IC-DISC); and
   - the addition of this income would **result in increased taxable income if it were included** on your tax return for the tax year.

3. Please note, similar to other regulations sections discussed above, proposed regulations were drafted for years after 1984 and will be applicable to the tax years you have under examination. Be sure that you refer to the proposed regulations where ever they are provided.
3. **The DISC Law and Major Concepts**

1. **Taxation of a DISC - IRC § 991**

1. Generally, a DISC is not subject to the tax under subtitle A of the Code (§§ 1-1564) with the exception of taxes imposed under chapter 5 of subtitle A (§§ 1491-1494) dealing with certain transfers to avoid tax. It will, however, be subject to all taxes imposed under other subtitles of the Code (for example – employment taxes and other taxes under subtitle C, the interest equalization tax and other excise taxes under subtitle D, etc.).
2. Although a DISC is not a taxable entity, the taxable income of a DISC must still be determined in order to determine the tax effect, if any, to the shareholders of a DISC. It is intended that the taxable income will be computed in the same manner as if it were a domestic corporation that did not make the election to be a DISC. This means that the DISC chooses its:

1. Accounting methods (see paragraph 3 immediately below),
2. Inventory method,
3. Elects, under IRC § 168(b)(3), different recovery percentages for its recovery property.[4]

1. Any elections affecting the determination of taxable income are made at the DISC level.
3. Treas. Reg. § 1.991-1(b)(2) places restrictions on the method of accounting the DISC may choose when dealing with a transaction between the DISC and other members of the same controlled group to which the DISC belongs.

1. The DISC may not choose a method of accounting which, when applied to transactions with members of the controlled group will result in a distortion of the income of the DISC or any member of the controlled group. (**See Treas. Reg. § 1.991-(b)(2) (both old and proposed) for examples of possible situations that would result in distortions.**)
4. A DISC is subject to the requirements of IRC § 446(e) and respective regulations for changes in accounting methods.
5. A DISC may not choose or change its taxable year without regard to the taxable year of the principal shareholder.[5]
2. **DISC Defined - IRC § 992**

1. The term "DISC" means any corporation that was created or organized under the laws of any State or the District of Columbia,[6] and meets the following conditions:

1. The gross receipts test described in Treas. Reg. § 1.992-1(b) –

   Ninety five (95) percent or more of the DISC's gross receipts (defined in Treas. Reg. §1.993-6) for the year must consist of QER (as defined in Treas. Reg. §1.993-1). (See Section III C below for a definition of gross receipts)
2. The assets test described in Treas. Reg. § 1.992-1(c) –

   The adjusted basis of its qualified export assets (defined in Treas. Reg. § 1.993-2) at the close of the year must equal or exceed ninety five (95) percent of the sum of the adjusted bases of all assets of the corporation at the close of the year. (See Section III D below for a definition of qualified export assets.)
3. The capitalization requirement described in Treas. Reg. § 1.992-1(d) –

   The DISC must have, on each day of that taxable year, only one class of stock. The par value (or, in the case of stock without par value, the stated value) of the corporation's outstanding stock must be on each day of the taxable year at least $2,500.

   In the case of a corporation which elects to be treated as a DISC for its first taxable year, the requirements are satisfied if the corporation has no more than one class of stock at any time during the year and if the par value (or, in the case of stock without par value, the stated value) of the corporation's outstanding stock is at least $2,500 on the last day of the period within which the election must be made and on each succeeding day of the year. This election however can cover two types of companies, one that was an already existing corporation and one that was newly formed for this one purpose.

The election for the first year of a “newly formed” corporation must be made within the 90 day period “after the beginning of the taxable year”. The election for the first year of an “existing” corporation must be made within the 90 day period immediately “preceding” the beginning of the taxable year. As you can see the dates for having the required capitalization in place can have very different beginning dates.

In the case of an “existing” corporation, the capitalization requirement begins on the first day of the year for which the corporation elects to be a DISC. Such an election would have been filed anytime within the 90 day period ending immediately before the first day of the taxable year for the election to be effective for that intended year. Therefore, the DISC does not have to have the full $2,500 value in place until the first day of the taxable year.

In the case of a “newly formed” corporation the regulations postpone the capitalization requirement until the last day (day 90) for filing the election. Even if the election is filed before that date it would appear that the newly formed corporation still has the full 90 days in which to issue the $2,500 value of stock to qualify.

For purposes of the $2,500 capitalization requirement the following rules apply:

1. The stated value of shares is the aggregate amount of the consideration paid for such shares which is not allotted to paid in surplus, or other surplus.
2. The law of the State of incorporation of the DISC determines what consideration may be used to capitalize the DISC.
3. A corporation will not be a qualified DISC unless at least $2,500 of valid consideration was used for this purpose.
4. If a corporation has a realized or unrealized loss during a taxable year which results in the impairment of all or part of the capital required under this condition, that impairment does not result in disqualification under this condition, provided that the corporation does not take any legal or formal action under State law to reduce capital for that year below the amount required under this condition.
5. The DISC may attempt to treat certain debt as stock. As a general rule debt of a DISC payable to any person, whether or not that person is a shareholder or a member of a controlled group of which the DISC is a member, is treated as debt for all purposes of the Code, provided that the debt:

0. Would qualify as debt for purposes of the Code if the DISC were a corporation which did not qualify as a DISC;
1. Qualifies under safe harbor rule (See Treas. Regs. § 1.992-1(d)(2)(ii)); or
2. Are trade accounts payable (See Treas. Regs. § 1.992-1(d)(2)(iii)).

4. It satisfies the requirement that an election to be treated as a DISC be in effect for such year as described in Temp. Treas. Reg. § 1.921-1T(b)(1)

1. To qualify as a DISC, a corporation must elect to be treated as a DISC by filing an election on Form 4876-A with the Internal Revenue Service Center in Cincinnati, Ohio.
2. A newly formed corporation can make an election on or before the 90th day after the beginning of its first taxable year.
3. Already existing corporations must make the election within the 90-day period before the beginning of the first taxable year in which it seeks to qualify as a DISC.
4. The election must be signed by any person authorized, under IRC § 6062, to sign the corporation's tax return. [7]
5. Once an election is made, it will, unless revoked by the corporation, continue in effect for subsequent years in which the corporation qualifies as a DISC. The election is still in effect even if the corporation fails, in intervening years, to meet the tests for qualification. However, if the corporation fails to qualify for five consecutive years, the DISC election will terminate. **See** IRC § 992(b)(1) and (2) for the procedure for, and the effect of, making a DISC election. [8]
6. For the election to be valid, all persons who were shareholders of the corporation on the first day of the initial election year must consent in writing. Consents must be filed with the statement of election unless there is reasonable cause for failure to file a particular consent with the election. [9]

0. In the consent, the shareholder agrees to be treated as a DISC shareholder with respect to distributions or deemed distributions of DISC income.
1. In the case of a foreign shareholder, the consent also represents the agreement of the shareholder that any distribution or deemed distribution of gains or other income to the foreign shareholder is effectively connected with the conduct of a trade or business in the United States through a permanent establishment.
2. The consent is binding on all subsequent shareholders of the corporation. [10]
3. The following person(s) must sign the consent [11]:

1. Where stock of the corporation is owned by a husband and wife as community property (or the income from the stock is community property), or is owned by tenants in common, joint tenants, or tenants by the entirety, each person having a community interest in the stock or the income there from and each tenant in common, joint tenant, and tenant by the entirety must consent to the election.
2. The consent of a minor must be made by his legal guardian or by his natural guardian if no legal guardian has been appointed.
3. The consent of an estate must be made by the executor or administrator of the estate.
4. The consent of a trust must be made by the trustee.

5. The consent of an estate or trust having more than one executor, administrator, or trustee, may be made by any executor, administrator, or trustee, authorized to make a return of such estate or trust pursuant to IRC § 6012(b)(5).
6. The consent of a corporation or partnership must be made by an officer or partner authorized pursuant to IRC §§ 6062 or 6063, as the case may be, to sign the return of such corporation or partnership.
7. In the case of a foreign person, the consent may be signed by any individual (whether or not a U.S. person) who would be authorized under IRC §§ 6061 through 6063 to sign the return of such foreign person if he were a U.S. person.
4. An election to be treated as a DISC may be revoked by the corporation any time after the first taxable year it is in effect. [12]

1. To be effective for a given taxable year, however, the revocation must be made on or before the 90th day of that year.
2. A revocation made after the expiration of the 90-day period will not be effective until the following taxable year.
3. The revocation must be signed by any person authorized to sign the corporations tax return under IRC § 6062.
4. A corporation that has terminated an election or has failed to qualify for five consecutive years may again elect to be a DISC. (**See** IRC § 992(b)(3) and Treas. Reg. § 1.992-2(e)(4)).
5. Treas. Reg. § 1.992-1(a)(7) & (8) added two more conditions:

1. The DISC must maintain a separate set of books and records.
2. Finally the DISC must not be an ineligible corporation described in IRC § 992(d) and Treas. Reg. § 1.992-1(f), which is the following:

0. An IRC § 501 exempt corporation;
1. An IRC § 542 personal holding company;
2. An IRC §§ 581 or 593 financial institution;
3. An insurance company under subject to tax under subchapter L;
4. An IRC § 851(a) regulated investment company;
5. China Trade corporation receiving an IRC § 941(a) deduction (repealed);
6. An S corporation.
2. Deficiency distributions to meet qualification requirements – Treas. Reg. § 1.992-3. If a corporation meets all of the requirements for treatment as a DISC other than the 95% gross receipts test, the 95% export assets test, or both tests the corporation may still qualify as a DISC by making deficiency distributions, but only if the following additional requirements are satisfied:

1. The corporation distributes the proper amounts;
2. The corporation satisfies the reasonable cause requirement of Treas. Reg. § 1.992-3(c)(1);

3. The corporation makes a deficiency distribution pro rata to all shareholders; and
4. The corporation designates the distribution, at the time of the distribution as a deficiency distribution in accordance with IRC § 992(c). [13]

1. The designation must be in the form of a communication sent at the time of the distribution to each shareholder and to the Service Center where the DISC return is filed.
2. A corporation may not retroactively designate a prior distribution as a deficiency distribution.
5. The computation of the amount of the distributions to meet the 95% gross receipts test can be found in Treas. Reg. § 1.992-3(b)(2).
6. The computation of the amount of the distributions to meet the 95% assets test can be found in Treas. Reg. § 1.992-3(b)(3).
7. The computation of the amount of the distribution in the event of a failure to meet both tests can be found in Treas. Reg. § 1.992-3(b)(4).
3. Section 805(b)(1)(A) of the Tax Reform Act of 1984 terminated all DISC and DISC elections as of December 31, 1984. This same provision then provided that a new election must be filed on the Form 4876A for corporations to continue to use the IRC §§ 991-997 rules as a DISC.
4. The proposed treasury regulations issued in 1984 have not been made final and the regulations have not been updated to reflect the changes brought about by the change in the law. The term DISC is still used through out the regulations. Any reference to DISC should be read to mean IC-DISC.
3. **Qualified Export Receipts - IRC § 993(a) & (f) and Treas. Reg. § 1.993-1**

1. IRC § 992(a)(1)(A) provides that for a corporation to qualify as a DISC, at least 95 percent of its "gross receipts" for a taxable year must consist of QER. This provision refers you to the definition of gross receipts under IRC § 993(f) and the definition of qualified gross receipts under IRC § 993(a).
2. Under IRC § 993(a)(1), the term QER means any of the eight amounts described in paragraphs (a) through (h) below, (except to the extent that any of the eight amounts would be an excluded receipt under subparagraph (2) of this section):

1. **Sales of export property.** — QER of a DISC include gross receipts from the sale of export property by the DISC, or by any principal for whom the DISC acts as a commission agent (whether or not such principal is a R-S). [14]

1. The sale must be pursuant to the terms of a contract entered into with a purchaser by the DISC or by the principal at any time or by any other person and assigned to the DISC or the principal at any time prior to the shipment of the export property to the purchaser. Examples of such an agreement would be:

0. a franchise agreement between the DISC and the R-S determining the parameters of the relationship between the two and the intercompany pricing methods selected and

1. Export promotion agreement spelling out the DISC's activities eligible for any additional benefits sought.
2. Any agreement, oral or written, which constitutes a contract at law, satisfies the contractual requirement of this paragraph.
3. Gross receipts from the sale of export property, whenever received, do not constitute QER, unless the seller (or the corporation acting as commission agent for the seller) is a DISC at the time of the shipment of the property to the purchaser.

0. For example, if a corporation which sells export property under the installment method is not a DISC for the taxable year in which the property is shipped to the purchaser, gross receipts from the sale do not constitute QER for any taxable year of the corporation.
2. **Leases of export property**

1. QER of a DISC include gross receipts from the lease of export property provided that [15] -

0. The property is held by the DISC (or by a principal for whom the DISC acts as commission agent with respect to the lease) either as an owner or lessee at the beginning of the term of the lease and
1. The DISC qualified (or was treated) as a DISC for its taxable year in which the term of such lease began.
2. Prepayment of lease receipts — If part or all of the gross receipts from a lease of property are prepaid, then:

0. All prepaid gross receipts are QER of a DISC if it is reasonably expected at the time of the prepayment that throughout the term of the lease they would be QER if received not as a prepayment or
1. If it is reasonably expected at the time of the prepayment that throughout the term of the lease they would not be QER if received not as a prepayment, then only those prepaid receipts, for the taxable years of the DISC for which they would be QER, are QER.

1. For example, if a lessee makes a prepayment of the first and last years' rent, and it is reasonably expected that the leased property will be export property for the first half of the lease period but not the second half of the period, the amount of the prepayment which represents the first year's rent will be considered QER if it would otherwise qualify, whereas the amount of the prepayment which represents the last year's rent will not be considered QER.
3. **Related and subsidiary services** - QER of a DISC include gross receipts from services furnished by the DISC which are related and subsidiary to any sale or lease (as described in (a) or (b) above) of export property by the DISC or with respect to which DISC acts as a commission agent, provided that the DISC derives QER from the sale or lease. The services may be performed within or without the United States. [16]

0. Services furnished by DISC. — Services are considered to be furnished by a DISC for purposes of this paragraph if the services are provided by —

1. The person who sold or leased the export property to which the services are related and subsidiary, provided that the DISC acts as a commission agent with respect to the sale or lease of the property and with respect to the services;
2. The DISC as principal, or any other person pursuant to a contract between the person and the DISC, provided the DISC acted as principal or commission agent with respect to the sale or lease of such property; or
3. A member of the same controlled group as the DISC where the sale or lease of the export property is made by another member of the controlled group provided that the DISC act as principal or commission agent with respect to the sale or lease and as commission agent with respect to the services.
1. Related services. — A service is related to a sale or lease of export property if the service is one that would be customarily and usually furnished with the type of transaction in the trade or business in which the sale or lease arose and the contract to furnish the service is:

1. Expressly provided for in or is provided for by implied warranty under the contract of sale or lease;
2. Entered into on or before the date which is 2 years after the date on which the contract under which the sale or lease was entered into. But only if the person who is to furnish the service delivers to the purchaser or lessor a written offer or option to furnish the services on or before the date that the first shipment of goods with respect to which the service is to be performed is delivered; or
3. A renewal of the services contract described in (a) or (b) above.
4. (d)Services which may be related to a sale or lease of export property include but are not limited to warranty service, maintenance service, repair service, and installation service.
5. Transportation (including insurance related to such transportation) may be related to a sale or lease of export property, provided that the cost of the transportation is included in the sale price or rental of the property or, if the cost is separately stated, is paid by the DISC (or its principal) which sold or leased the property to the person furnishing the transportation service.
6. Financing, or the obtaining of financing, for a sale or lease is not a related service.
2. Subsidiary services - Services related to a sale or lease of export property are subsidiary to the sale or lease only if it is reasonably expected at the time of the sale or lease that the gross receipts from all related services furnished by the DISC will not exceed 50 percent of the sum of the gross receipts from such sale or lease and the gross receipts from related services furnished by the DISC. [17]

1. In the case of a sale, reasonable expectations at the time of the sale are based on the gross receipts from all related services which may reasonably be expected to be performed at any time before the end of the 10-year period following the date of such sale.
2. In the case of a lease, reasonable expectations at the time of the lease are based on the gross receipts from all related services which may reasonably be expected to be performed at any time before the end of the term of such lease (determined without regard to renewal options).
3. In determining whether the services related to a sale or lease of export property are subsidiary to the sale or lease, the gross receipts to be treated as derived from the furnishing of services may not be less than the amount of gross receipts reasonably allocated to the services as determined under the facts and circumstances of each case without regard to whether the services are furnished under a separate contract or under the same contract pursuant to which the sale or lease occurs or the cost of the services is specified in the contract of sale or lease.
3. Transactions involving more than one item of export property. - If more than one item of export property is sold or leased in a single transaction pursuant to one contract, the total gross receipts from that transaction and the total gross receipts from all services related to that transaction are each taken into account in determining whether the services are subsidiary to that transaction. However, this rule applies only if the items could be included in the same product line, as determined under Treas. Reg. § 1.994-1(c)(7).
4. Renewed service contracts. - If under the terms of a contract for related services, the contract is renewable within 10 years after a sale of export property, or during the term of a lease of export property, related services to be performed under the renewed contract are subsidiary to that sale or lease if it is reasonably expected at the time of the renewal that the gross receipts from all related services which have been and which are to be furnished by the DISC will not exceed 50 percent of the sum of (a) the gross receipts from such sale or lease and (b) the gross receipts from related services furnished by the DISC. Reasonable expectations are determined as provided in 3(a) & (b) above.
5. Parts used in services. - If a services contract provides for the furnishing of parts in connection with the furnishing of related services, gross receipts from the furnishing of such parts are not taken into account in determining whether under this subparagraph the services are subsidiary. See Treas. Reg. § 1.993-1(a) & (b) for guidance on how to determine whether the gross receipts from the furnishing of parts constitute QER. See Treas. Reg. §1.993-3(c)(2)(iv) and (e)(3) for rules regarding the treatment of such parts with respect to the manufacture of export property and the foreign content of such property.
6. Prepaid receipts for services related and subsidiary to a lease - If there are prepaid gross receipts for the performance of services that are related and subsidiary services to a lease of export property, and all the services are to be performed before the end of the term of the lease, then some or all of those receipts may qualify as QER.

1. For example, if it is reasonably expected that leased property will be export property for the first year of the term of the lease but will not be export property for the second year of the term, prepaid gross receipts for related and subsidiary services to be furnished in the first year may be QER. However, any prepaid gross receipts for such services to be furnished in the second year cannot be QER.
7. The determination as to whether gross receipts from the sale or lease of export property constitute QER does not depend upon whether services connected with that sale or lease are related and subsidiary to the sale or lease.

1. For example, assume that a DISC receives gross receipts of $1,000 from the sale of export property and gross receipts of $1,100 from installation and maintenance services which are to be furnished by the DISC within 10 years after the sale and which are related to the sale. The $1,100 which the DISC receives for the services would not be QER since the gross receipts from the services exceed 50 percent of the sum of the gross receipts from the sale and the gross receipts from the related services furnished by the DISC. The $1,000 which the DISC receives from the sale of export property would, however, be a QER if the sale itself met the requirements.
4. QER of a DISC include gross receipts from the sale by the DISC of assets, other than export property, which, as of the date of the sale, are qualified export assets (as defined in Treas. Reg. §1.993-2). Gross receipts are derived from the sale of these assets only where the sale results in recognized gain (See Treas. Reg. §1.993-6(a)). Losses from the sale of the qualified export assets shall not be taken into account for purposes of determining the DISC's QER. [18]
5. QER of a DISC for a taxable year include all dividends includible in the gross income of the DISC for the taxable year with respect to the stock of related foreign export corporations (as defined in Treas. Reg. § 1.993-5) and all amounts includible in the gross income of the DISC with respect to the corporations pursuant to section 951 (relating to amounts included in the gross income of U.S. shareholders of controlled foreign corporations). [19]
6. QER of a DISC include interest on any obligation which is a qualified export asset of the DISC, including any amount includible in gross income as interest (i.e., an amount treated as original issue discount pursuant to IRC § 1232) or as imputed interest under IRC § 483. Gain from the sale of obligations that qualify as export assets is treated (to the extent such gain is not treated as interest on such obligations) as QER pursuant to paragraph (d) above. [20]
7. QER of a DISC include gross receipts from engineering services or architectural services furnished by the DISC for a construction project located, or proposed for location, outside the United States. The services may be performed within or without the United States. [21]

0. Services included. —Engineering and architectural services include feasibility studies for a proposed construction project whether or not such project is ultimately initiated.
1. Excluded services. —Engineering and architectural services do not include:

1. Services connected with the exploration for minerals or
2. Technical assistance or know-how.

1. The term “technical assistance or know-how” includes activities or programs designed to enable business, commerce, industrial establishments, and governmental organizations to acquire or use scientific, architectural, or engineering information.
2. Receipts from the performance of construction activities other than engineering and architectural services constitute QER to the extent that the activities are related and subsidiary services (see (c) above) with respect to a sale or lease of export property.
3. Engineering services in connection with any construction project include any professional services requiring engineering education, training, and experience and the application of special knowledge of the mathematical, physical, or engineering sciences to such professional services as consultation, investigation, evaluation, planning, design, or responsible supervision of construction for the purpose of assuring compliance with plans, specifications, and design.
4. Architectural services include the offering or furnishing of any professional services such as consultation, planning, aesthetic, and structural design, drawings and specifications, or responsible supervision of construction (for the purpose of assuring compliance with plans, specifications, and design) or erection, in connection with any construction project.
5. Architectural and engineering services are considered furnished by a DISC if such services are provided —

1. By the DISC,
2. By another person (whether or not a United States person) pursuant to a contract entered into by such person with the DISC at any time prior to the furnishing of the services, provided that the DISC acts as principal with respect to the furnishing of the services, or
3. By another person (whether or not a United States person) pursuant to a contract for the furnishing of the services entered into at any time prior to the furnishing of the services provided that the DISC acts as commission agent with respect to the services.
6. The term “construction project” includes the erection, expansion, or repair (but not including minor remodeling or minor repairs) of new or existing buildings or other physical facilities including, for example, roads, dams, canals, bridges, tunnels, railroad tracks, and pipelines. The term also includes site grading and improvement and installation of equipment necessary for the construction. Gross receipts from the sale or lease of construction equipment are not QER unless the equipment is export property (as defined in Treas. Reg. §1.993-3).
8. QER of a first DISC for its taxable year include gross receipts from the furnishing of managerial services provided for another (second) DISC, which is not a related person, to aid the unrelated DISC in deriving QER, provided that at least 50 percent of the gross receipts of the first DISC for the year consists of QER derived from the sale or lease of export property and the furnishing of related and subsidiary services. Managerial services are considered furnished by a DISC if the services are provided: [22]

0. By the first DISC,
1. By another person (whether or not a United States person) pursuant to a contract entered into by the person with the first DISC at any time prior to the furnishing of the services, provided that the first DISC acts as principal with respect to the furnishing of the services, or
2. By another person (whether or not a United States person) pursuant to a contract for the furnishing of the services entered into at any time prior to the furnishing of the services provided that the DISC acts as commission agent with respect to the services.

The term “managerial services” for these purposes means activities relating to the operation of another unrelated DISC which derives QER from the sale or lease of export property and from the furnishing of services related and subsidiary to the sales or leases. The term includes staffing and operational services necessary to operate the other DISC, but does not include legal, accounting, scientific, or technical services.

Examples of managerial services are:

1. Export market studies,
2. Making shipping arrangements, and
3. Contacting potential foreign purchasers.
3. Excluded receipts [23] — QER of a DISC do not include any of the five amounts described below:

1. Sales and leases of property for ultimate use in the United States. —Property which is sold or leased for ultimate use in the United States does not constitute export property (relating to determination of where the ultimate use of the property occurs). See Treas. Reg. § 1.993-3(d)(4).
2. Sales of export property accomplished by subsidy. - QER of a DISC do not include gross receipts from the sale of export property which is pursuant to any of the following:

1. The development loan program, or grants under the technical cooperation and development grants program of the Agency for International Development, or grants under the military assistance program administered by the Department of Defense, pursuant to the Foreign Assistance Act of 1961, as amended (22 U.S.C. 2151), unless the DISC shows to the satisfaction of the Service that, under the conditions existing at the time of the sale, the purchaser had a reasonable opportunity to purchase, on competitive terms and from a seller who was not a U.S. person, goods which were substantially identical to such property and which were not manufactured, produced, grown, or extracted (as described in Treas. Reg. § 1.993-3(c)) in the United States,
2. The Public Law 480 program authorized under Title I of the Agricultural Trade Development and Assistance Act of 1954, as amended (7 U.S.C. 1691, 1701-1710).

3. The Export Payment Program of the Commodity Credit Corporation authorized by sections 5(d) and (f) of the Commodity Credit Corporation Charter Act, as amended (15 U.S.C. 714c(d) and (f)),
4. The section 32 export payment programs authorized by section 32 of the Act of August 24, 1935, as amended (7 U.S.C. 612c), and
5. For taxable years beginning after November 3, 1972, the Export Sales program of the Commodity Credit Corporation authorized by sections 5(d) and (f) of the Commodity Credit Corporation Charter Act, as amended (15 U.S.C. 714c(d) and (f)), other than the GSM-4 program provided under 7 CFR 1488, and section 407 of the Agricultural Act of 1949, as amended (7 U.S.C. 1427), for the purpose of disposing of surplus agricultural commodities and exporting or causing to be exported agricultural commodities.
3. Sales or leases of export property and furnishing of engineering or architectural services for use by the United States.

1. For example - a sale by a DISC of export property to the Department of Defense for use outside the United States would not produce QER for such DISC if the Department of Defense purchased such property from appropriated funds subject to any provisions of the Armed Forces Procurement Regulations (32 CFR Subchapter A, Part 6, Subpart A) or any appropriations act for the Department of Defense for the applicable year which restricts the availability of such appropriated funds to the procurement of items which are grown, reprocessed, reused, or produced in the United States.
2. Any sale or lease of export property is considered for use by the United States or an instrumentality of the United States if the property is sold or leased by a DISC (or by a principal for whom the DISC acts as commission agent) to —

0. A person who is a related person with respect to the DISC or the principal and who sells or leases property for use by the United States or an instrumentality thereof or
1. A person who is not a related person with respect to the DISC or the principal if, at the time of the sale or lease, there is an agreement or understanding that the property will be sold or leased for use by the United States or an instrumentality thereof (or if a reasonable person would have known at the time of the sale or lease that the property would be sold or leased for use by the United States or an instrumentality thereof) within 3 years after the sale or lease.
3. The provisions do not apply in the case of a purchase by the United States or an instrumentality thereof if such purchase is pursuant to:

0. The Foreign Military Sales Act, as amended (22 U.S.C. § 2751 et seq.), or a program under which the U.S. Government purchases property for resale, on commercial terms, to a foreign government or agency or instrumentality thereof, or
1. A program (whether bilateral or multi-lateral) under which sales to the U.S. Government are open to international competitive bidding.

2. QER of a DISC do not include gross receipts that are related and subsidiary services to the sale or lease of property which itself results in excluded receipts. [24]
3. Receipts within controlled group — Gross receipts of a corporation do not constitute QER for any taxable year of such corporation if:

1. At the time of the sale, lease, or other transaction resulting in gross receipts, the corporation and the person from whom the receipts are directly or indirectly derived are members of the same controlled group and
2. The corporation and the person each qualifies as a DISC for its taxable year in which its receipts arise.

1. Example 1- Assume that R, S, X, and Y are members of the same controlled group and that X and Y are DISC's. If R sells property to S and pays X a commission relating to that sale and if S sells the same property to an unrelated foreign party and pays Y a commission relating to that sale, the receipts received by X from the sale of such property by R to S will be considered to be derived from Y, a DISC which is a member of the same controlled group as X, and thus will not result in QER to X. The receipts received by Y from the sale to an unrelated foreign party may, however, result in QER to Y.
2. Example 2- R and S both assign the commissions to X, receipts derived from the sale from R to S will be considered to be derived from X acting as commission agent for S and will not result in QER to X. Receipts derived by X from the sale of property by S to an unrelated foreign party, may, however, constitute QER.
3. A controlled group for purposes of IRC §§ 991 through 996 and the regulations related to these sections has the same meaning as used in IRC § 1563(a) except that instead of 80% you would substitute 50% for DISC controlled groups. [25]
4. **Qualified Export Assets - IRC § 993(b) and Treas. Reg. § 1.993-2(a).**

1. For a corporation to qualify as a DISC, at the close of its taxable year at least 95 percent of the sum of the adjusted bases of all its assets must be qualified export assets.

1. For purposes of this test an asset that qualifies as more than one type of qualified export asset may be taken into account only once in determining the sum of the adjusted bases of all qualified export assets.
2. The definition of qualified export asset for purposes of this test is found in IRC § 993(b) and Treas. Reg. § 1.993-2(a) as follows:

1. Export property – Is essentially inventory assets and more detail can be found in Treas. Reg. § 1.993-3 (Also see paragraph E of this section for a more in depth discussion of export property).
2. Business assets – Are assets (other than inventory type assets [26]) used by the DISC primarily in connection with:

1. The sale, lease, storage, handling, transportation, packaging, assembly, or servicing of export property, or

2. The performance of engineering or architectural services or managerial services in furtherance of the production of QER.
3. Trade receivables – Accounts receivable and other evidences of indebtedness derived from transactions that generated QER between the DISC and the party with which it conducts business.

1. If the DISC acts as a commission agent for a principal in a transaction that produces QER then the trade receivables will be the accounts receivable of the principal.

1. If the principle is a R-S to the DISC, the account receivable will not be treated as a trade receivable or other qualified export asset unless it is payable and paid in the time and manner specified in Treas. Reg. § 1.994-1(e)(3) (i.e., 60 days after the close of the year of the DISC).
2. An indebtedness arising under Treas. Reg. § 1.994-1(e)(3)(iii) (relating to initial payment of transfer price of commission) in favor of a DISC is not a qualified export asset.
3. An indebtedness arising from adjustments to transfer price or commission under Treas. Reg. § 1.994-1(e)(5)(i) in favor of a DISC is a trade receivable but only if it is paid in the time and manner described in Treas. Reg. § 1.994-1(e)(5)(i) (i.e., 90 days after the date it is established) and (ii) relating to form of payment (i.e., money, property, a written obligation that qualifies as debt under the safe harbor provisions of Treas. Reg. § 1.992-1(d)(2)(ii)) and if it otherwise satisfies the requirements of a qualified asset.
4. Temporary investments - described in Treas. Reg. § 1.993-2(e), are:

1. Money, bank deposits (not including time deposits of more than 1 year), and other similar temporary investments maintained by a DISC as reasonably necessary to meet its working capital needs.

1. The working capital of a DISC is the excess of its current assets over current liabilities.

0. Current assets are cash and other assets (other than trade receivables) which may reasonably be expected to be converted into cash or sold or consumed during the current normal operating cycle of the DISC's trade or business,
1. Current liabilities are obligations (or portions of obligations) due within the current normal operating cycle of the trade or business of the DISC whose satisfaction when due is reasonably expected to require the use of current assets,
2. Generally accepted financial accounting treatments will be accepted, and
3. Current assets (other than temporary investments) are taken into account before temporary investments, and trade receivables are never taken into account, in determining whether such temporary investments are maintained by the DISC as reasonably necessary to meet its current liabilities and its requirements for working capital.
2. Determination of the amount of money, bank deposits, and other similar temporary investments reasonably necessary to meet the requirements of the DISC for working

capital will depend upon the nature and volume of the activities of the DISC existing at the end of the DISC's taxable year for which the determination is made, for example —

0. In the case of a DISC which purchases and sells inventory, the amount of working capital reasonably required is limited to an amount reasonably necessary to meet:
    - the ordinary operating expenses during the current normal operating cycle of the trade or business of the DISC,
    - an amount reasonably needed to meet specific and definite plans for expansion, and
    - any amounts necessary for reasonably anticipated extraordinary business expenses.
1. In the case of a DISC which actively conducts a trade or business (including the employment of a sales force) and receives commissions in respect of goods to which such DISC does not have title, the amount of working capital required will depend upon the nature and volume of the activities of the DISC which produce income as they exist on the applicable determination date. In determining the amount of working capital which is reasonably required for the production of such income, the anticipated future needs of the business will be taken into account to the extent that such needs relate to the year of the DISC following the applicable determination date. Anticipated future needs relating to a later period will not be taken into account, unless it is clearly established that such needs are reasonably related to the production of such income as of the applicable determination date.
2. In the case of a DISC which does not actively conduct a trade or business, and which receives commissions solely by reason of Treas. Reg. § 994(a)(1), (a)(2), or (b) with respect to goods to which the DISC does not have title, no working capital would be required beyond a de minimis amount, unless it appears from the facts and circumstances that additional working capital will be required.
3. In the case of a DISC deriving income from the leasing of property, the amount of working capital required will be determined on the basis of the facts and circumstances in each case.
3. A temporary investment is an obligation, (including an evidence of indebtedness), which is a demand obligation or has a period remaining to maturity of not more than 1 year at the date it is acquired by the DISC.
4. A temporary investment does not include trade receivables.
5. Producer's loans - defined in Treas. Reg. § 1.993-4 (see paragraph F of this section for further detail);
6. Stock or securities of related foreign export corporations - defined in Treas. Reg. § 1.993-2(g);
7. Export-Import Bank and other obligations - described in Treas. Reg. § 1.993-2(h);
8. Financing obligations - described in Treas. Reg. § 1.993-2(i); and
9. Funds awaiting investment - described in Treas. Reg. § 1.993-2(j).

5. **Export property - IRC § 993(c)**

1. For the DISC to generate any tax-favored treatment, it must have QER. Most of the gross receipts that generate QER come from the sale, lease or rental of “export property”. So in the typical case, your analysis of QER will most likely begin with the definition of export property. [27]

   The property sold or leased must satisfy four criteria to be considered export property. [28] The property must:

1. Be manufactured, produced grown or extracted in the U.S, by a person other than a DISC;
2. Be held in the ordinary course of business for foreign use, consumption and disposition outside of U.S.;

1. This criteria consists of four additional requirements or tests:

   - A destination test,
   - component parts test,
   - Proof of compliance with the destination test, and
   - Use outside the U.S. test.

3. Have no more than 50% of its fair market value from articles imported into the U.S. (foreign content test); and
4. Not be disqualified as export property under IRC § 993(c)(2) and Treas. Reg. § 1.993-3(f).
2. Services can never be export property. [29] Treas. Reg. § 1.993-3(b).
3. The DISC definition of qualified export property is similar (but not identical) to the definitions of qualified export property and qualifying foreign trade property under FSC and ETI, respectively. Therefore, many of the rulings and or decisions relative to FSC or ETI in this area may be relevant to interpreting the DISC definition of qualified export property.
4. Since export property must be manufactured, produced, grown or extracted in the U.S., how you define manufacturing is a key element in determining whether the DISC has QER from the sale of export property. Defining manufacturing should therefore be our logical beginning point.

1. What is manufacturing?

1. Manufacturing is defined at Treas. Reg. § 1.993-3(c)(2). The regulations use (with some modification) the subpart F definition of manufacturing found at Treas. Reg. § 1.954-3(a)(4).
2. In general terms, the subpart F regulation defines manufacturing as any of the following:

0. “Substantial transformation” of purchased property prior to sale:

0. Examples of substantial transformation include the conversion of wood pulp to paper, steel rods to nuts, bolts and screws and the canning of fish.

1. Performs activities on purchased property that are substantial in nature and generally considered to constitute manufacture or production, or construction of property, or
2. Incurs Conversion costs (direct labor and factory burden) that account for 20% or more of the total cost of goods sold or the adjusted basis for such property.

0. Conversion costs included assembly and packaging costs but not parts under a service contact. See Treas. Reg. § 1.993-3(c)(2)(iv).
3. Packaging, repackaging, labeling and minor assembly are not manufacturing Treas. Reg. § 1.954-3(a)(4)(iii). But see Bausch and Lomb v. Commissioner, TCM 1996-57 (1996) below.
3. Selected developments in the definition of manufacturing.

0. **David Fishbein Manufacturing Co. v. Commissioner**, 59 TC 338 (1972). This case involved the definition of manufacturing for the purposes of subpart F. The Tax Court held the assembly of bag-closing machines were substantial in nature where taxpayer "(a) tailors and finishes some of its purchased components in order to place these parts in usable condition; (b) puts these tailored components and others together in a 6-hour, 58-step process to form salable, quality bag-closing machines; and (c) possesses in its plant all of the tools and equipment necessary for these activities…. There is nothing minor, insignificant, or insubstantial about the utilization of proper equipment, by trained personnel, in a time-consuming process which has, as its final result, a high-caliber, portable bag-closing machine."
1. **Webb Export Corp. v. Commissioner**, 91 TC 131 (1988). The DISC "purchased standing timber, had a normal size crew fell the trees, clean the branches off as necessary and cut the trees into veneer logs." The activities were held to be substantial in nature and generally considered to constitute production of property within the meaning of Treas. Reg. § 1.993-3(c)(2). [30] In arriving at this conclusion, the court considered that: "(1) loggers consider themselves to be producers; (2) standing timber is not particularly useful to manufacturers; (3) substantial activities are required before such materials are useful to manufacturers; and (4) the items considered to be raw materials and who is perceived to be a producer, varies depending upon one's position in the manufacturing and/or production process."
2. **Garnac Grain Co. v. Commissioner**, 95 TC 7 (1990). The taxpayer's business consisted primarily of purchasing grain (soybeans, corn, and wheat); cleaning, drying, aerating, fumigating, and blending this grain; and then selling it for export to customers. The court held that taxpayer had not carried their burden of demonstrating that the taxpayer was engaged in production because the taxpayer did not establish that their activities with respect to grain storage and handling are generally considered in the industry to constitute production.
3. **Bausch & Lomb, Inc. v. Commissioner**, TCM 1996-57 (1996). The Tax Court held that taxpayer's full range of activities necessary to assemble sunglass parts into finished, quality sunglasses were substantial in nature. Such activities involved the following: 1)

leased production facilities to assemble sunglasses, 2) employed management teams to prepare production plans and order parts from their suppliers, 3) hired and trained the necessary personnel to carry out their operations, 4) inspected purchased parts for defects and prepared those parts for assembly, 5) assembled sunglass parts into finished sunglasses, 6) inspected finished sunglasses for cosmetic and functional defects, and 7) cleaned and packaged sunglasses to prepare them for distribution. The court found that assembly operations required a trained and experienced workforce. While conceding that the assembly operations did not require a large investment in physical capital, the court noted that they required a large investment in human capital. The court also rejected government's assertion that operations require substantial amounts of time to complete to be substantial in nature. The court also took into consideration that the high-end sunglass industry would consider the operations to constitute the manufacture or production of property. This case expanded the definition of what constitutes manufacturing and clouded the concept of minor assembly.

4. **Audit suggestion**. Determining whether activities constitute the production or manufacturing of property can be very fact intensive. If you think you have an issue concerning the definition of manufacturing, contact the DISC Technical Advisor for assistance.
2. Who must manufacture the property?

1. The property must be manufactured by someone other than a DISC. [31] **See Webb Export**, 91 TC 31 (1988), as discussed above, where a DISC violated this rule.
2. Typically the property is manufactured by the R-S(s).

0. A R-S is a "related party" that directly supplies to a DISC any property or services that the DISC disposes of in a transaction producing QER or a related party that uses a DISC as a commission agent in a disposition of property or services that produces QER. A R-S is sometimes referred to as the operating company.
3. If the DISC manufactured the property at a time when it was not a DISC, the property would not qualify as export property to the DISC. [32]
3. What is the location where the manufacturing must occur?

1. Generally the property must be manufactured in the U.S. For purposes of IRC §§ 991 to 997, the term United States includes the 50 states, the District of Columbia, and Puerto Rico. [33]
2. If the property is manufactured in the U.S. and then sustains **further manufacturing** outside of the U.S. prior to sale it will not be considered export property. [34]
4. What about where it is clear that the actual manufacturing takes place in the U.S., but one or more of the component parts used in the manufacturing process are imported into the U.S.?

1. In this case we look to the “foreign content test” or “the 50% test” of Treas. Reg. § 1.993-3(e).

0. The 50% test says provides no more than 50% of the fair market value (“FMV”), can be attributed to the FMV of articles imported into the U.S.

0. Articles imported into the U.S. are considered “foreign content.”
1. Foreign content is computed under the rules of Treas. Reg. § 1.993-3(e)(4).
2. FMV of foreign content is the appraised value as determined under § 402 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with their importation.
3. The appraised value is the full dutiable value.
1. Evidence of the FMV of the foreign content may be the Customs invoice issued on the importation of the article or by a certification based upon information contained in the customs invoice and furnished to the holder by a person from whom the articles were purchased. [35]
2. Generally, the 50% foreign FMV test is applied on an item by item basis. However, if the taxpayer sells a large volume of substantially identical items with substantially identical foreign content in substantially the same proportion, the items can be aggregated to determine the portion of foreign content. Treas. Reg. § 1.993-3(e)(2).
3. An article imported into the U.S. is treated as entirely imported even if all or a portion of the article was originally manufactured in the U.S. [36]
4. A special rule applies for interchangeable parts. The rules applies when identical or similar component articles are imported into the U.S. and others are manufactured in the U.S. The determination of whether or not imported articles are incorporated in the export property will be made on a substitution bases as in the case of the rules relating to draw back accounts under the Customs law. For further clarification please see the example at Treas. Reg. § 1.993-3(e)(4)(iii)(b).
5. The next criteria to consider in determining if property qualifies as export property is to determine if the property was “held” primarily for sale or lease in the ordinary course of business and such sale or lease was for the direct use, consumption, or disposition of the export property outside of the U.S.

1. The direct use, consumption or disposition outside of the U.S. requirement has three parts, which focus on:

1. Destination,
2. Documents to satisfy proof of compliance, and
3. Use outside the U.S.
2. Each requirement is discussed below. As evidenced by the number of court cases, the destination test has generated the most controversy. You should carefully review these rules.

1. Destination test – Treas. Reg. § 1.993-3(d)(2) - Property must be sent outside of the U.S. to satisfy the destination test. The FOB point, or the place where title or risk of loss shift from seller or lessor are **not** important. The key factors are the place of delivery and to whom the export property is delivered.

   The destination test is satisfied with respect to property sold or leased by the seller or lessor only if it is delivered by the seller or lessor-

0. **Within the U.S.** to a carrier or freight forwarder for ultimate delivery outside the U.S. to a purchaser or lessee (or a subsequent purchaser or sub-lessee).
1. **Within the U.S.** to a purchaser or lessee, if the property is ultimately delivered outside the U.S. (including delivery to a carrier or freight forwarder for delivery outside the U.S.) by the purchaser or lessee (or a subsequent purchaser or sub-lessee) within the one year after the sale or lease.
2. **Within or outside the U.S.** to a purchaser or lessee which, at the time of the sale or lease, is an interest charge DISC and is not a member of the same controlled group as the seller or lessor.
3. **From the U.S.** to a purchaser or lessee (or a subsequent purchaser or sub-lessee) at a point outside the U.S. by means of the seller's or lessor's own ship, aircraft, or other delivery vehicle, owned, leased, or chartered by the seller or lessor.
4. **Outside the U.S.** to a purchaser or lessee from a warehouse, storage facility, or assembly site located outside the U.S., if the property was previously shipped by the seller or lessor from the U.S.
5. **Outside the U.S.** to a purchaser or lessee if the property was previously shipped by the seller or lessor from the U.S. **and if the property is located outside the U.S. pursuant to a prior lease by the seller or lessor, and either**:

0. the prior lease terminated at the expiration of its term,
1. the sale occurred or the term of the subsequent lease began after the time at which the term of the prior lease would have expired, or
2. the lessee under the subsequent lease is not a related person with respect to the lessor and the prior lease was terminated by the action of the lessor acting alone or together with the lessee.
6. The Destination Test regulations contain three additional rules in Treas. Reg. § 1.993-3(d)(2)(ii), (iii) and (iv).

0. Any relationship between the seller or lessor and any purchaser, subsequent purchaser, lessee, or sublessee is immaterial, (exception for (1)(c) and (1)(f) above).
1. In no event is the destination test satisfied with respect to property which is subject to any use (other than a resale or sublease), manufacture, assembly, or other processing (other than packaging) by any persons between the time of the sale or lease by such seller or lessor and the delivery, or ultimate delivery outside the U.S.

2. If property is located outside the U.S. at the time it is purchased by a person or leased by a person as lessee, such property may be export property in the hands of such purchaser or lessee only if it is imported into the U.S. prior to its further sale or lease (including a sublease) outside the U.S. See below for discussion of property manufactured in U.S. and subject to further manufacture.
3. Selected Cases and Rulings re the destination test. Since the FSC rules are similar to the DISC rules in this regard, many decisions reached for FSCs may also apply to DISCs.

1. Further manufacturing in the U.S prior to export.

0. General Electric Co. v. Commissioner, T.C. Memo. 1995-306, rev'd in part, vacated in part, and remanded, 245 F.3d 149 (2d Cir. 2001). [37]

   General Electric ("GE") manufactured aircraft engines and thrust reversers in the U.S. and sold them through its commission DISC to foreign airline companies as well as to U.S. manufacturers. Prior to being exported, these products were installed on the airplane sold by U.S. airframe manufacturers to foreign airlines. The installation process was performed in the U.S. This process involved 110 to 160 hours of constructing a build-up consisting of over 2,000 parts from more than 40 different vendors and then using four bolts to attach the engine to the plane. Finally, an additional 60 to 65 hours were required to attach the reversers to the airplane. The Tax Court held the U.S. airframe manufacturers' activities to constitute further manufacturing, assembling, or other processing under Treas. Reg. § 1.993-3(d)(2)(iii) disqualifying the aircraft engines and reversers from being export property under Treas. Reg. § 1.993-3.

   However, on appeal, the Second Circuit reversed the decision of the Tax Court on the engines issue and vacated the Tax Court's judgment on the thrust reversers issue. Specifically, the Second Circuit held that the attachment of engines to an airframe does not constitute assembly or other processing under Treas. Reg. § 1.993-3(d)(2)(iii). The Second Circuit reasoned that the airframes and engines were distinct from each other physically (for example, routine removal and replacement); legally (for example, under FAA regulations and Government determinations); and commercially (for example, separate marketing and negotiations between the component-maker and the end user of the final product). The Second Circuit described the activities as follows: "when [the airframe manufacturers] installed the engines on the airframes, [they] were not moving the engines along toward completion, or substantially changing them…. Rather, [the airframe manufacturers] were simply affixing a completed export product (an engine that was itself already in the form in which it was to be delivered) to another product (an airframe)."

   In addition, the Second Circuit observed that engines and thrust reversers may differ materially. Because the Tax Court's analysis did not differentiate between the engines

and the thrust reversers, the Second Circuit sent the issue back to the Tax Court for further consideration in light of its opinion.

2. The goods must be exported within one year of sale. Treas. Reg. § 1.993-3(d)(2)(i)(b).

0. General Dynamics Corp. v. Commissioner, 108 T.C. 107 (1997). Petitioners manufactured two specialized vessels that were designed and built for transoceanic transport of liquefied natural gas. The tankers were manufactured under contract for sale to a company for direct use outside the United States. After the completion, but before the tankers could be used for foreign purposes, unforeseen delays caused some domestic use of one of the tankers. The delay also caused both tankers not to be placed in foreign commerce prior to 1 year after their sale.

   The court cited **Sim-Air, USA, Ltd. v. Commissioner**, 98 T.C. 187 (1992), and held that the Treas. Reg. § 1.993-3(d)(2)(i)(b) one year requirement was not met. The court stated that Treas. Reg. § 1.993-3(d)(2)(i)(b) does not provide any exception for reasonable delay or unforeseen events. Thus, the taxpayer did not have export property.

   Sim-Air, USA, Ltd. v. Commissioner, 98 T.C. 187 (1992). In 1981, the taxpayer purchased a helicopter from Bell Helicopter. The taxpayer intended to use the helicopter in a joint venture in Egypt, but the joint venture never materialized. In 1985, taxpayer transferred back the helicopter to Bell Helicopter and taxpayer claimed the proceeds on the helicopter transfer as QER. Bell Helicopter did not export it to the purchaser until later that year. Tax Court held the helicopter was not export property because Bell Helicopter did not export the helicopter within one year as required under Treas. Reg. § 1.993-3(d)(2)(i)(b). [38]

1. See also PLR 8436028, 1984 WL 267617 (IRS PLR) and Rev. Rul. 72-581, 1972-2 C.B. 461.

0. PLR 8436028 deals with a U.S. company that manufactured product M. This product was sold to another U.S. company that only installed the product on a rack and plugged the product into a socket. Within one year of sale the final end product (including product M) was shipped outside the U.S. as per the original invoicing instructions. Ultimate use was found to be outside the U.S. for the product.

1. Rev. Rul. 72-581 deals with paint that was used on U.S. registered and foreign vessels. The Rev. Rul. stated, “[p]aint and related products which are applied for protection and/or beautification of a surface are ‘used’, within the meaning of section 993(c)(1)(B) of the Code at the point where such products are applied and permanently affixed to such surface.” Following this rationale, the Rev. Rul. held that “where paint is applied to a vessel in U.S. ports, the paint is not ‘used’ outside the U.S..… However, where paint is applied to a vessel on the high seas or at foreign ports, the paint is used outside the United States as required by section 993(c)(1)(B)…”

4. The documents that the taxpayer must supply as proof that it has complied with the destination test are listed at Treas. Reg. § 1.993-3(d)(3).

1. To prove delivery outside the United States. — The seller or lessor (DISC or R-S in most cases) must establish the ultimate delivery, use, or consumption of property outside the United States by providing —

0. A facsimile or carbon copy of the export bill of lading issued by the carrier who delivers the property,
1. A certificate of an agent or representative of the carrier disclosing delivery of the property outside the United States,
2. A facsimile or carbon copy of the certificate of lading for the property executed by a customs officer of the country to which the property is delivered,
3. If such contract has no customs administration, a written statement by the person to whom delivery outside the United States was made,
4. A facsimile or carbon copy of the shipper's export declaration, a monthly shipper's summary declaration filed with the Bureau of Customs, or a magnetic tape filed in lieu of the Shipper's Export Declaration, covering the property, or
5. Any other proof (including evidence as to the nature of the property or the nature of the transaction) which establishes to the satisfaction of the Commissioner that the property was ultimately delivered, or directly sold, or directly consumed outside the United States within 1 year after the sale or lease.
2. The requirements for proof of destination will be considered satisfied even though the name of the ultimate consignee and the price paid for the goods is marked out provided that, in the case of a Shipper's Export Declaration or other document listed in such (e) above or a document such as an export bill of lading such document still indicates the country in which delivery to the ultimate consignee is to be made and, in the case of a certificate of an agent or representative of the carrier, that the document indicates that the property was delivered outside the United States.
3. A seller or lessor must also establish they met the requirement that the property was delivered outside the United States without further use, manufacture, assembly, or other processing within the United States.
4. Sale or lease to an unrelated DISC. — a purchaser or lessee of property is deemed to qualify as a DISC for its taxable year if the seller or lessor obtains from the purchaser or lessee a copy of the purchaser's or lessee's election to be treated as a DISC with the purchaser's or lessee's sworn statement that the election has been filed with the Internal Revenue Service Center.

0. The copy of the election and the sworn statement of the purchaser or lessee must be received by the seller or lessor within 6 months after the sale or lease.
1. A purchaser or lessee is not treated as a DISC with respect to a sale or lease during a taxable year for which the purchaser or lessee does not qualify as a DISC if the seller or

lessor does not believe or if a reasonable person would not believe at the time the sale or lease is made that the purchaser or lessee will qualify as a DISC for the taxable year.

5. If a seller or lessor fails to provide proof of compliance with the destination test the property sold or leased is not export property.
5. Delivery outside of the U.S. is not enough. Another test – the use test—focuses on where the property is ultimately used, consumed, or disposed. The property must be used or consumed outside the U.S. Treas. Reg. § 1.993-3(d)(4) provides the rules for the use test.

1. Property will be deemed to be for ultimate use in the U.S., and **not export property**, if :

0. The purchaser is related [39] to the seller and the purchaser ultimately uses the property, or a second product into which the property is incorporated, as a component in the U.S., or
1. At the time of sale, there is an agreement or understanding that the property, or a second product into which the property is incorporated as a component, will be ultimately used by the purchaser in the U.S.,

0. An agreement or understanding is found to exist if a component is sold abroad with the express agreement with, or an indication from, the foreign purchaser that the component will be incorporated into a product to be sold back to the U.S.
1. Such an agreement or indication does not result from the mere fact that a second product into which the exported component has been incorporated and which is sold on a world market is sold in substantial quantities into the U.S.
2. At the time of sale a reasonable person would have believed that the property or second product would be ultimately used by the purchaser in the U.S. But there is an exception for components that are manufactured at more than one location.
2. Property will be deemed to be used in the U.S., and not export property, if the “3-year rule” is violated. Treas. Reg. § 1.993-3(d)(4)(iii).

0. Under this three year rule property (including components incorporated into a second product) is or would be ultimately used in the U.S. by the purchaser if at any time within 3 years after the purchase of either the property, or the components (or the second product into which the components are incorporated) are resold by the purchaser for use by a subsequent purchaser within the U.S. or the purchaser or subsequent purchaser fails, for any period of 365 consecutive days, to use the property or second product predominately outside the U.S. as defined below.
3. **Sales to retailers.** Property sold to any person whose principal business consists of selling from inventory to retail customers at retail outlets outside of the U.S. will be considered to be used predominantly outside the U.S.
4. Treas. Reg. § 1.993-3(d)(vii) - Defines a component as property which is (or reasonably expected to be) incorporated into a second product by the purchaser of such component by means of production, manufacture, or assembly.

5. “Predominant use” outside of U.S is defined in Treas. Reg. 1.993-3(d)(vi) as property located outside of the U.S. more than 50% of the time.

0. An aircraft, railroad rolling stock, vessel, motor vehicle, container, or other property used for transportation purposes is deemed to be used predominantly outside the U.S. if for any period, during that period either:

0. The property is located outside the U.S. more than 50% of the time, or
1. More than 50% of the miles traversed in the use of the property are traversed outside the U.S.
1. Property is deemed to be within the U.S at all times during which it is engaged in transportation between any two points within the U.S., except where the transport constitutes uninterrupted international air transportation within the meaning of IRC § 4262(c)(3).

0. IRC § 4262(c)(3) provides that the term “uninterrupted international air transportation” means any transportation by air which is not transportation by air which begins in the United States or in the 225-mile zone and ends in the United States or in the 225 mile zone and in which

1. the scheduled interval between i) the beginning or end of the portion of such transportation which is directly or indirectly from one port or station in the Untied States to another port or station in the United States and ii) the end or beginning of the other portion of such transportations is not more than 12 hours, and
2. the scheduled interval between the beginning or end and the end or beginning of any two segments of the portion of such transportation referred to in (i) above is not more than 12 hours.
1. An orbiting satellite is deemed to be located outside the U.S. [40]
6. Use outside of the U.S. IRC § 993(c)(1)(B)

1. **FMC Corp. v. Commissioner**, 100 T.C. 595 (1993). Taxpayer, a U.S. corporation, manufactured industrial cranes, and sold them through its commission DISC. Some of the cranes were sold to U.S. companies for use on oil drilling platforms attached to the Outer Continental Shelf of the U.S. in the Gulf of Mexico, more than 3 miles but less than 200 miles, from the coastline of any U.S. state, U.S. possession, or Puerto Rico.

   The Court referred to IRC § 638, where U.S. is defined to include adjacent territorial waters, seabed, and subsoil of the submarine areas with regard to which the U.S. has exclusive exploration and exploitation rights. The court held that the cranes were not used outside of the U.S. because the oil drilling activities of the crane purchasers were within the territorial waters described in IRC § 638.

7. For purposes of the use test related to leases of export property you must focus on where the property is ultimately used, consumed or disposed. For leases, the property must be used “predominantly” outside of the U.S.

1. In general, predominantly outside the U.S. test is satisfied if the property is physically located outside of the U.S. more than 50% of the lessor's tax year.

0. Note that this is a year by year test. For example, Assume the lessor used the property outside the U.S. 75% of the time during years 1 and 4, but only 25% outside of the U.S. in years 2 and 3. In that case the lessor could have QER in years 1 and 4, but not years 2 and 3.
6. Special rule for fungible goods – the FSC regulations provide a special segregation rule for fungible goods. [41] The rule requires fungible export property, such as grain be physically segregated from non-export property at all times after purchase by a FSC, or after the start of the commission relationship between the FSC and the R-S. The FSC requirement for segregation relating to fungible goods came about because of problems occurring during the DISC regime identifying whose fungible goods were in fact exported and how one could document that their goods were delivered outside the U.S.

   The DISC regulations do not have a similar rule. Instead, the DISC regulations provide that export property need not be physically segregated from non-export property. [42] However, Rev. Rul. 77-484 found that gross receipts derived by a farmer from grain to a farmers' cooperative, which mixes the grain with grain from other farmers in its storage facility and fills both domestic and foreign orders from such storage facilities, do not constitute QER under IRC § 993(a)(1).

   After Rev. Rul. 77-484 was issued many fungible goods exporters, and cooperatives set up systems for segregation that would satisfy the export property rules and they have operated under that system ever since.
7. **Property excluded from qualifying as export property** - Even when all of the above requirements to be export property are satisfied, if the property is described below, it is not export property.

1. Property sold to a related DISC is **not** export property [43];
2. Generally, property leased or rented to a member of the same controlled group (whether or not they are a DISC) is not export property [44];

1. Exception - if the related member holds the property for subleases or subleases the property to an unrelated person (third party) who uses the property predominately outside of the U.S., the property may be export property. [45]
3. Most intangible property (with the exception of certain copyright rights) is **not export property**. [46]
8. Computer software may qualify as export property.

1. TRA of 1997 amended IRC § 927(a)(2)(B), which was identical in wording to IRC § 993(c)(2)(B), to explicitly include computer software (whether or not patented) in the definition of export property for receipts attributable to periods after 12/31/97.
2. **See** Treas. Reg. § 1.861-18 for a definition of copyrights for computer software.
3. **See Microsoft Corp. v. Commissioner**, 115 T.C. 228 (2000), the Tax Court held that rights in computer software licensed for reproduction abroad are included in the definition of export property under IRC § 927(a)(2)(B) even absent the TRA amendment on 12/31/97.
4. Intangible rights in "film characters" developed by the U.S. taxpayer are not export property. They do not qualify as copyrights to films, tapes, records or similar property. See FSA 200019021.

9. Depletable products, such as oil, gas coal or uranium (or any primary product thereof), generally are **not export property**. [47]

1. A list of what constitutes a primary product of these depletable products can be found in Treas. Reg. 1.993-3(g)(3). Note that this list of products is not intended to represent the only products and the list may be changed from time to time to reflect changing technology.

10. Products subject to Export Controls are **not export property**. [48]

1. A product is considered an export controlled product if at a particular time it is prohibited or curtailed under Section 4(b) of the Export Administration Act of 1969 or Section 7(a) of the Export Administration Act of 1979 or any other similar act.

11. Products that are listed by the President as being in short supply are **not export property**. [49]

1. This refers to the Department of Commerce ("DOC") regulations regarding products in short supply. Subsequent to 1987, the DOC changed the numbering of its regulations and now the products in short supply are located at 15 CFR 754.
2. Also note that by executive order, the President can declare a product to be in short supply. When this happens, the DOC adds that product to its short supply regulations.
3. The product must be on the short supply list at the time it was exported. If you need to verify whether a product was on the list at a given time, you may:

1. call the DOC at 202-482-4811 or
2. go to www.bis.doc.gov.

0. When the home page loads, look to the left hand column and find and select the link "Export Administration Regulations." Once in this link scroll down to Part 754 for a list of the current items on the short supply list.

12. Unprocessed timber which is a softwood is not export property. [50]
13. Services are not export property.[51]

6. **Producer's Loans – IRC § 993(d)**

   Before we move on to the intercompany pricing rules some discussion regarding producer's loans is probably prudent.

1. Included in the definition of qualified export assets was the term "producer's loans". This term was defined in Treas. Reg. § 1.993-4 as a loan made by a DISC to a person referred to as the borrower if:

1. The loan is made out of accumulated DISC income as described in Treas. Reg. § 1.993-4(a)(3);
2. The loan is evidenced by an obligation described in Treas. Reg. § 1.993-4(a)(4);
3. The loan is made to a borrower who is engaged in the U.S. in the manufacture, production, growth, or extraction of export property;

1. The borrow may be engaged in other trades or business; and
2. The loan does not need to be traceable to a specific investment in export property.
4. See **Garnac Grain Co., Inc. v. Commisioner**, 95 T.C. 7 (1990).
7. **Intercompany Pricing Rules - IRC § 994(a)**

   When there is a transaction between a R-S and a DISC, the related person may determine the transfer price to be charged to the DISC by its choice of one of three pricing method. The rules for these three methods can be found in IRC § 994(a) and (b). IRC § 994(a) relates to the rules for sales of export property and IRC § 994(b) relates to the rules for commissions, rentals, and marginal costing.

1. When export property is sold by a R-S through a DISC, the DISC's taxable income will be based on a transfer price that will allow the DISC to realize a taxable income in an amount that does not exceed:

1. 4% of the QER on the sale by the DISC plus 10% of the export promotion expenses;
2. 50% of the CTI of the DISC attributable to the QER on such property derived as a result of the sale plus 10% of the export promotion expenses; or
3. The taxable income based upon the sales price actually charged but subject to the rules of IRC § 482.

1. The IRC § 482 method is rarely used for the following of reasons.

0. It is beneficial only if the DISC performs economic functions and **incur** risks that simply may not exist if the DISC is nothing more than a shell company. The other two methods do not require any functions or risks be performed by the DISC. [52]
1. When this method is properly applied, the portion of the income that would receive DISC benefit may be less than if one of the other two methods were used.

2. The cost of performing the economic analysis to establish the arm's length transfer price may offset the tax benefit derived from electing DISC status.
2. All three methods only address transactions between a DISC and a R-S.
3. R-S is defined at Treas. Reg. § 1.994-1(a)(3) as:

0. A **related party** which singularly engages in a transaction directly with the DISC which is subject to the rules of IRC § 994.
1. These same regulations define a related party as a person which is owned or controlled directly or indirectly by the same interest as the DISC within the meaning of IRC § 482.
2. If either of the first two methods is used (4% of QER or 50% of CTI) the Service may not propose distributions, allocations or apportionments under IRC § 482 with respect to the amount so determined. [53]
3. No Loss Rule [54] - if either the 4% QER method or the 50% CTI method is used it is subject to a "no loss" rule. This rule provides that the neither method may be applied if it would cause a loss to the R-S.

1. A loss is defined as when the taxable income of the DISC (Part I - Sections B & C of Schedule P) would exceed the CTI of the R-S and the DISC (Part I Section A of Schedule P).

1. The obvious starting point then would be to compute the CTI before computing the DISC taxable income. This is consistent with the format of the Form 1120 IC DISC - Schedule P.
2. If there is no CTI of the R-S and the DISC (meaning there is already a loss before the transfer price or commission was determined) then the transfer price or commission will not be deemed to cause a loss to the R-S if it allows the DISC to recover an amount not in excess of its costs.
3. Special rule for 4% QER to sales – This method will not be considered to cause a loss for the R-S if the ratio of (DISC taxable income / DISC gross receipts) is not greater than the ratio of (R-S & DISC taxable income / R-S & DISC gross receipts).
4. See the example in Treas. Reg. § 1.994-1(e)(1)(ii).
4. How does a commission DISC differ from a buy-sell DISC?

1. A **commission DISC** does not take title to the goods. Instead, the R-S sells the export property directly to the customer for use abroad. The DISC earns a commission on the sale. The commission DISC is generally the more common arrangement.
2. A **buy-sell DISC** buys the export property from the R-S, takes title and then resells the property to a customer for use abroad.
3. The taxable income of both the DISC and the R-S will be the same regardless of whether the DISC is a commission DISC or a buy-sell DISC. However the transfer prices will be different. This is illustrated below.

1. IRC § 994(a) provides that the taxable income of a DISC shall be based upon a transfer price which would allow the DISC to derive profit attributable to such sale in an amount which does not exceed the greatest of:

   - 4% of QER plus 10% DISC export promotion expenses,
   - 50% of CTI plus 10% DISC export promotion expenses, or
   - the IRC § 482 profit

2. The taxpayer can use the method that provides the maximum DISC income.
5. **What is CTI?** - CTI is the sum of the DISC's and the R-S's taxable income from a sale of export property. The calculation of CTI for commission DISCs and buy/sell DISCs differ slightly. For buy/sell DISCs, CTI equals DISC's gross receipts from sale of export property less the sum of R-S's and DISC's expenses (excluding amount paid to R-S for export property) which related to such gross receipts For commission DISCs, CTI equals R-S's gross receipts from sale of export property less R-S's expenses (excluding commission paid to DISC) and DISC's expenses related to such gross receipts.

1. Generally, the principles of Treas. Reg. § 1.861-8 through -17 are used to compute CTI.
6. Examples of the application of the transfer pricing rules:

1. **Example 1 - Commission DISC** – This example illustrates the CTI method and 4% QER method.

1. Facts:

   - J is an individual calendar year taxpayer.
   - J owns 100% of U.S. corporation K which elects to be a DISC.
   - J manufactures product W in the U.S. Product W qualifies as export property under IRC § 993(c).
   - K signs a franchise agreement to sell product W outside the U.S. for a commission.
   - J sells the property to an unrelated party for $1,000.
   - J's cost of goods sold attributable to the export property is $650.
   - J's direct and indirect expenses incurred in connection with the sale per the rules of Treas. Reg. § 1.861-8 are $200.
   - The DISC incurs export promotion expenses attributable to the sale of $50.

2. 1120-IC-DISC Schedule P calculation – Part 1 Section A - CTI:

Part I - Section A – Schedule P		
	Amount	**On Tax**

Part I - Section A – Schedule P		
		Return of
Line 1 – QER	$1,000	R-S
Line 2a – Cost of Sales	650	R-S
Line 2b – Expenses of R-S	200	R-S
Line 2c – DISC Exp. Promo Exp.	50	DISC
Line 3 – CTI	100	Neither

3. Schedule P - Part B – DISC Taxable Income under the 50% of CTI Method - The profit of the DISC is 50% of the $100 CTI plus 10% of the $50 export promotion expenses for a total of $55 computed as follows:

Part I - Section B – Schedule P	
Line 13 – CTI	$100
Line 14 – 50% of CTI	$50
Line 15 – 10% of 2c	5
Line 17 – DISC Tax. Inc.	$55

4. The maximum allowable DISC commission from J (which is also the commission income of the DISC) which will give the DISC a profit of $55 is as follows:

Part III – Schedule P	
Line 27 – DISC Tax. Inc.	$56
Line 28 – DISC Expt. Prom. Exp.	$50
Line 29 – DISC Other Exp.	
Line 30 – DISC Commission	$105

5. The tax returns of the J and K will look as follows:

Tax Return of J (R-S)		**Tax Return of K (DISC)**	
Sales	$1,000	Commission Income	$105
Cost of Sales	-650	DISC Expenses	-50
Gross Profit	350	Profit	$55
Expenses of R-S	-200		
DISC Comm. Exp.	-105		
Income	45		

6. **Schedule P Part C – DISC Taxable Income under the 4% QER method** - Under this method the profit of the DISC is 4% of the $1,000 QER plus 10% of the $50 export promotion expenses or $45 computed as follows:

Part I - Section C – Schedule P	
Line 18 – QER line 1	**$1,000**
Line 19 – 4% of Line 18	**$40**
Line 20 – 10% of 2c	**5**
Line 21 – DISC Tax. Inc.	**$45**

7. The maximum allowable DISC commission from J (as well as the Commission income of the DISC) which will give the DISC a profit of $45 is as follows:

Part III – Schedule P	
Line 27 – DISC Tax. Inc.	$45
Line 28 – DISC Expt. Prom. Exp.	$50

Part III – Schedule P	
Line 29 – DISC Other Exp.	
Line 30 – DISC Commission	$95

8. The respective tax returns will look as follows:

Tax Return of J (R-S)		**Tax Return of K (DISC)**	
Sales	$1,000	Commission Income	$95
Cost of Sales	-650	DISC Expenses	-50
Gross Profit	350	Profit	$45
Expenses of R-S	-200		
DISC Comm. Exp.	-95		
Income	$55		

9. In this case, the DISC and R-S would choose to use the 50% of CTI method because it will result in greater tax-favored treatment.

2. **Example 2 - Buy-sell DISC** - This example illustrates the CTI and 4% QER intercompany pricing methods in regards to a buy-sell DISC.

1. Facts: Are the same as the previous example except as follows.
2. **1120-IC-DISC Schedule P – Part 1 Section A – CTI calculation**

Part I –Section A –Schedule P		
	Amount	**On Tax Return of**
Line 1 – QER	$1,000	DISC
Line 2a – Cost of Sales	650	R-S
Line 2b – Expenses of R-S	200	R-S
Line 2c – DISC Exp. Promo. Exp.	50	DISC
Line 2d – Other DISC Exp.	0	-

Part I –Section A –Schedule P		
Line 3 – CTI	100	Neither

3. **Schedule P - Part B – DISC taxable income under the 50% of CTI Method for a buy-sell DISC** – The profit of the DISC is 50% of the $100 CTI plus 10% of the $50 export promotion expenses – ($55 = $50+$5).

Part I -Section B – Schedule P	
Line 13 - CTI	$100
Line 14 – 50% of CTI	$50
Line 15 – 10% of 2c	5
Line 17 - DISC Tax. Inc.	$55

4. The transfer price (instead of a commission) which will give the DISC a profit of $55 is as follows:

Part II –Schedule P	
Line 24 - QER	$1,000
Line 25 - Less reductions	
a. DISC Taxable Income	55
b. DISC Export Promotion Expenses	50
c. Other DISC Expenses	-
Line 26 - Transfer Price from DISC to R-S	$895

5. The respective tax returns will look as follows:

Tax Return of J (R-S)		**Tax Return of K (DISC)**	
Sales	$895	FTGR	$1,000
Cost of Sales	-650	Cost of Sales	-895
Gross Profit	255	Gross Profit	105
Expenses of R-S	-200	DISC Expense	-50
Income	45	Profit	55

6. **Schedule P - Part B – DISC Taxable Income under the 4% of QER Method for a buy-sell DISC** - The profit of the DISC is 4% of the $1,000 QER plus 10% of the $50 export promotion expenses or $45 computed as follows:

Part I - Section C – Schedule P	
Line 18 – QER line 1	$1,000
Line 19 – 4% of Line 18	$40
Line 20 – 10% of 2c	5

Part I - Section C – Schedule P	
Line 21 – DISC Tax. Inc.	$45

7. The transfer price which will give the DISC a profit of $45 is as follows:

Part II –Schedule P	
Line 24 - QER	$1,000
Line 25 - Less reductions	
a. DISC Taxable Income	45
b. DISC Export Promotion Expenses	50
c. Other DISC Expenses	-
Line 26 - Transfer Price from DISC to R-S	$905

8. And once more the respective tax returns will look as follows:

Tax Return of J (R-S)		Tax Return of K (DISC)	
Sales	$905	FTGR	$1,000
Cost of Sales	-650	Cost of Sales	-905
Gross Profit	255	Gross Profit	95
Expenses of R-S	-200	DISC Expense	-50
Income	55	Profit	45

Similar to the result in the first example, this taxpayer would use the CTI method since it would provide the most advantageous tax reduction.

3. **Example 3** - Buy-sell DISC that performs functions substantial enough to entitle it to use IRC § 482 Pricing method under IRC § 925(a)(3).

1. Facts: The same facts as example 1 above except:
    - Instead of a commission franchise agreement, K is a buy-sell DISC.
    - J sells product W to K for $750, a price which can be justified as satisfying the arm's length standard of IRC § 482.
    - J's cost of goods sold attributable to the export property sold to K is $600.
    - K resells the property to an unrelated party for $1,000 and performs significant operating functions.
    - K incurs expenses attributable to the sale of $220 of which $20 are export promotion expenses.
    - J's direct and indirect expenses incurred in connection with the sale per the rules of Treas. Reg. § 1.861-8 are $120.
2. 1120-IC-DISC Schedule P - CTI calculation – Part 1 Section A

Schedule P Part I – Section A - IC-DISC Taxable Income		
	Amount	**On Tax Return of**
Line 1 – QER (K's Sale Price)	$1,000	DISC
Line 2a – J's Cost of Sales	600	R-S
Line 2b - Expenses of R-S	120	R-S
Line 2c – DISC Exp. Promo. Exp.	200	DISC
Line 2d- Other DISC Exp.	20	DISC
Line 3 - CTI	60	Neither

3. Schedule P - Part I Section B - 50% of CTI Method – The profit of the DISC is 50% of the $60 CTI plus 10% of the $200 export promotion expenses – computed as follows:

Part I -Section B – Schedule P	
Line 13 - CTI	$60
Line 14 – 50% of CTI	$30
Line 15 – 10% of 2c	20
Line 17 – DISC Tax. Inc.	$50

4. Schedule P Part I Section C - 4% of QER Method - The profit of the DISC is 4% of the $1,000 QER plus 10% of the $200 export promotion expenses computed as follows:

Part I - Section C – Schedule P	
Line 18 – QER line 1	$1,000
Line 19 – 4% of Line 18	$40
Line 20 – 10% of 2c	20

Part I - Section C – Schedule P	
Line 21 – DISC Tax. Inc.	$605

5. When using the IRC § 482 method you do not use Schedule P. Instead the profit under this method is computed as follows:

K's sale price	**$1,000**
Less:	
K's Cost of Goods Sold	750
K's Profit	220
K's Net Profit	30

6. Since the 4% gross receipts method results in a greater profit for K ($60) and does not exceed the CTI ($60), K may earn a maximum profit of $60 computed as follows:

Part II –Schedule P	
Line 24 - QER	$1,000
Line 25 - Less reductions	
a. DISC Taxable Income	60
b. DISC Export Promotion Expenses	200
c. Other DISC Expenses	20
Line 26 - Transfer Price from R-S to DISC	$720

7. Accordingly the transfer price from J to K may be readjusted as long as it does not go below $720.
8. See other examples in Treas. Reg. § 1.994-1(g).
4. **Example 4** - Application of the “no loss rule”.

1. What happens when the CTI statement shows a loss?

1. Assume the following facts:

Schedule P Part I – Section A - IC-DISC Taxable Income		
	Amount	**On Tax Return of**
Line 1 QER	$1,000	R-S
Line 2 Cost of Sales		R-S
a – Cost of Goods Sold	650	R-S
b – Expenses of R-S	130	
c – DISC Exp. Promo. Exp.	220	R-S
d – Other DISC Exp.	10	DISC
Line 3 - CTI	-10	Neither

2. Since there already is a loss the DISC commission would not "cause a loss" to occur. The "no loss" rule of Treas. Reg. § 1.994-1(e) prevents the DISC from making a profit when

there is no CTI from a transaction, or group of transactions. The DISC can recover its costs, however, so the transfer price and tax returns would be computed as shown below.

1. Assume the following facts:

Schedule P Part I – Section A		
	Amount	**On Tax Return of**
Line 1 QER	$1,000	R-S
Line 2 Cost of Sales		R-S
a – Cost of Goods Sold	650	R-S
b – Expenses of R-S	100	
c – DISC Exp. Promo. Exp.	230	R-S
d – Other DISC Exp.	-0-	DISC
Line 3 - CTI	20	Neither

2. Neither the 4% QER method nor the CTI method may be applied to cause a loss to the R-S in a taxable year. Either method however, may be applied to the extent that it does not cause a loss. Treas. Reg. § 1.994-1(g) Ex 1.
3. **Schedule P - Part I Section B - 50% of CTI Method** – The profit of the DISC is 50% of the $20 CTI plus 10% of the $230 export promotion expenses limited to the CTI – computed as follows:

Part I -Section B – Schedule P	
Line 13 - CTI	$20
Line 14 – 50% of CTI	10
Line 15 – 10% of 2c	23
Line 16 – Add lines 14 & 15	33
Line 17 - DISC Tax. Inc. smaller of 13 or 16	$20

4. Schedule P Part I Section C - 4% of QER Method - The profit of the DISC is 4% of the $1,000 QER plus 10% of the $230 export promotion expenses limited to the CTI - computed as follows:

Part I - Section C – Schedule P	
Line 18 – QER line 1	$1,000
Line 19 – 4% of Line 18	40
Line 20 – 10% of 2c	23
Line 21 – Add 19 & 20	63
Line 22 - CTI	20
Line 23 DISC Tax. Inc. Smaller of 21 or 22	20

5. The transfer price and tax returns would be computed as shown below.

Part III – Schedule P	
Line 27 DISC taxable income	$20

Part III – Schedule P	
Line 28 DISC Export Promo Exp	230
Line 29 Other DISC Expenses	-0-
Line 30 DISC Commission from R-S	$250

6. The respective tax returns will look as follows:

Tax Return of R-S		**Tax Return of K (DISC)**	
Sales	$1,000	Commission Income	$250
Cost of Sales	-650	DISC Expenses	-230
Gross Profit	350	Profit	20
Expenses of R-S	-100		

Tax Return of R-S		**Tax Return of K (DISC)**	
DISC Commission Expense	-250		
Income	-0-		

3. The rules regarding the accounting methods that must be used in computation of combined taxable income are found at Temp. Treas. Reg. § 1.994-1(c)(6) and are summarized as follows:.
1. Generally, the taxpayer's method of accounting used in computing taxable income will be accepted provided:
1. the accounting method used by the DISC and R-S is permissible under IRC § 446(c) and
2. the method chosen does not cause a material distortion of income of the DISC or any member of its controlled group.
2. The cost of goods sold must be determined in accordance with the provisions of § 61-3. IRC §§ 471 and 472 and the regulations thereunder provide rules for accounting for inventory.
3. Costs other than the cost of goods sold are allocated and apportioned under the principles of Treas. Reg. §§ 1.861-8 to -17.
4. The taxpayer's choice of grouping of transactions is controlling and costs deducted in a taxable year will be allocated and apportioned to the items or classes of gross income resulting from those grouping choices.

7. Initial payment of transfer price or commission. See Treas. Reg. § 1.994-1(e)(3).

1. Transfer prices actually charged by a related supplier to a DISC or a sales commission actually charged by a DISC to a related supplier must be paid within 60 days following the close of the taxable year of the DISC during which the transaction took place.
2. The form of payment must be in money, property (including accounts receivable from sales by or through the DISC), a written obligation which qualifies as debt under the safe harbor rule of Treas. Reg. § 1.992-1(d)(2)(ii), or an accounting entry offsetting the account receivable against any existing debt owed by the person in whose favor the account receivable was established to the person with whom it engaged in the transaction.

3. If the DISC fails to pay the transfer price or sales commission (or a reasonable estimate of the transfer price or sales commission) within the 60 day timeframe, then an indebtedness will be deemed to arise on the date of the transaction giving rise to such indebtedness.

1. Such indebtedness owed to a DISC shall be treated as an asset, but shall not be treated as a trade receivable or other qualified export asset as of the end of the taxable year of the DISC in which the indebtedness is deemed to arise.
2. The DISC may now be at risk of failing the 95% qualified export asset requirement under IRC § 992(a)(1)(B).
3. If the DISC fails the 95% qualified export asset requirement, it may be able to cure the failure through a deficiency distribution under Treas. Reg. § 1.992-3.
8. Adjustment of transfer price or commission. **See** Treas. Reg. § 1.994-1(e)(5).

1. If the transfer price (or commission) for a transaction determined under IRC § 994 is different from the price actually charged then an appropriate account receivable and account payable shall be deemed established at the date of the determination.

1. The DISC's account receivable must be paid within 90 days.
2. If the DISC's account receivable is not paid within 90 days then the debt will be deemed to arise at the end of the DISC's taxable year in which the transaction occurred. However, the account receivable will not be treated as a qualified export asset.

1. The DISC may now be at risk of failing the 95% qualified export asset requirement under IRC § 992(a)(1)(B).
2. If the DISC fails the 95% qualified export asset requirement, it may be able to cure the failure through a deficiency distribution under Treas. Reg. § 1.992-3.
2. In lieu of establishing an account receivable, the DISC and R-S may treat all or part of any distribution made out of the DISC's previously taxed income in the year of the determination as an additional payment of the transfer price or a repayment of the commission.

1. To the extent the distribution is treated as an additional payment of the transfer price or a repayment of the commission, such amount is no longer a distribution for any federal income tax purpose.

1. DISC previously taxed income should be readjusted.
2. Where the R-S and DISC are brother-sister entities, Rev. Proc. 85-45 permits the DISC to treat distributions to its shareholder as a an additional payment of the transfer price or a repayment of the commission. The excess cash held by the DISC shareholder is treated as a loan from the R-S to the DISC shareholder.
8. **Marginal Costing Pricing Rules of IRC § 994(b)**

1. IRC § 994(b) provides for another set of pricing rules, the marginal costing ("MC") rules. The IRC § 994(b) authorizes the Treasury Secretary to prescribe regulations

establishing rules for taxpayers who are seeking to establish a foreign market for sales of an item, product or product line of export property. These rules apply only to a taxpayer who uses the 50% CTI method for computing DISC taxable income. [55]

2. MC is a method under which only marginal or variable costs of producing and selling a particular item, product or product line are taken into account for purposes of computing CTI. [56]

1. Variable costs are defined as:

1. Direct production costs defined in Treas. Reg. § 1.471-11(b)(2)(i) as costs which are incident to and necessary for production or manufacturing operations or processes and are components of the cost of either direct material and direct labor, [57]

1. Direct material costs include the cost of those materials which become an integral part of the specific product and those materials which are consumed in the ordinary course of manufacturing and can be identified or associated with particular units or groups of units of that product.
2. Direct labor costs include the cost of labor which can be identified or associated with particular units or groups of units of a specific product. The elements of direct labor costs include such items as basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under IRC § 105(d)), shift differential, payroll taxes and payments to a supplemental unemployment benefit plan paid or incurred on behalf of employees engaged in direct labor.

2. Costs which are export promotion expenses, but only if they are claimed as such in computing the DISC taxable income under the 50% CTI method.

2. The MC rules may be elected by a taxpayer that is seeking to establish or maintain a foreign market for sales of an item, product, or product line of export property from which QERs are derived. A DISC is treated as seeking to establish or maintain a foreign market if the CTI computed under the MC rules is greater than the CTI under the full costing rules of Treas. Reg. § 1.994-1(c)(6).[58]

1. The MC–CTI is limited by the overall profit percentage (“OPP”) this limitation is called the overall profit percentage limitation (“OPPL”). [59]

1. The OPP is computed by dividing full costing CTI of the DISC and the R-S plus all the other taxable income of the R-S from all sales of a product or product line (domestic + foreign) by the worldwide sales of that product or product line and multiplying the result by QER from the relevant transaction. [60]
2. If greater, the **MC CTI** (subject to the OPPL) and not the full costing CTI may be used to determine the DISC’s income under the 50% CTI pricing method.
3. The DISC’s profit determined under these rules cannot exceed the limits imposed by the MC no loss rule which is similar to the no loss rules discussed earlier. [61]

2. Significant case law in this area –

1. **Brown-Forman Corp. v. Commissioner**, 94 T.C. 919 (1990), **aff'd**, on a different issue, 955 F.2d 1037 (6th Cir. 1992), **cert. denied**, 506 U.S. 827 (1992).

   When the Tax Court upheld the validity of Treas. Reg. § 1.994-2(b) the Court made the following statement:

   The OPPL renders the marginal costing method beneficial only to those taxpayers whose profit margin for export sales -- determined under a full costing method -- is less than their worldwide profit margin with respect to sales of such product or product line. We find such effect reasonable in that it excludes from marginal costing taxpayers who logically would not need special tax incentives to be encouraged to export -- i.e., those taxpayers whose export profit margin already is higher than their worldwide profit margin with respect to the product in question. Taxpayers already enjoying a higher profit margin on export sales than on worldwide sales of a product or product line hardly would seem to be those Congress had in mind when it granted the Commissioner regulatory authority in section 994(b)(2) to allow special rules for those "seeking to establish or maintain a market for export property." Id. at 944-45.

2. **Dow Corning Corp. v. United States**, 984 F.2d 416 (Fed Cir. 1993). The Federal Circuit Court of Appeals affirmed the U.S. Claims Court decision that upheld the validity of Treas. Reg. § 1.994-2(b)(3).

4. MC grouping rules similar to the rules for full costing CTI are discussed below.
5. Example 1 – MC Rules increase DISC profits under 50% of CTI Method.

   This example shows that when the domestic sales are more profitable than export sales, MC can increase DISC profits.

1. Facts:

	Domestic	**Export**
Sales	$1,000	1,000
Cost of Sales (Direct Exp)	600	600

	Domestic	Export
Other expenses	100	200
Taxable income	300	200

2. Schedule P (Rev. 12-2008) of the DISC will look as follows:

Part I - Section A-1 – Schedule P		
	Amount	**Return**
Line 1 QER Line	1,000	R-S
2a Cost of Sales	600	R-S
Line 2b R-S Expenses	100	R-S
Line 2c DISC Exp. Prom. Exp.	75	DISC
Line 2d Other DISC Exp.	25	DISC
Line 2e Add 2a-2d	800	

Part I - Section A-1 – Schedule P		
Line 3 CTI	200	
Part I – Section A-2 - Schedule P		
Line 4 QER	1,000	
Line 5a Direct Material	400	
Line 5b Direct Labor	200	
Line 5c Exp. Prom. Exp	75	
Line 6 CTI b/4 OPPL	325	
Line 7 Sales For. & Dom	2,000	
Line 8a COGS	1,200	

Part I - Section A-1 – Schedule P		
Line 8b Exp (R-S & DISC)	300	
Line 9 Full Costing CTI	500	
Line 10 OPP (Line 9 /Line 7)	25%	
Line 11 OPPL (Line 4 X Line10)	250	
Line 12 MC CTI (Smaller Line 6 or Line 11)	250	

Part I - Section B - Schedule P	
Line 13 CTI (Line 3 or Line 12)	250.00
Line 14 (Line 13 X 50%)	125.00
Line 15 10% Exp Prom Exp	7.50

Part I - Section B - Schedule P	
Line 16 Add Lines 14 and 15	132.50
Line 17 IC-DISC Taxable Income Enter smaller of Line 13 or Line 16	132.50
Part 1 - Section C – 4 % of QER	
Line 18 QER (Line 1)	1,000.00
Line 19 Multiply line 1 by 4%	40.00
Line 20 Multiply line 2c by 10%	7.50
Line 21 Add Lines 19 and 20	47.50
Line 22 CTI	200.00
Line 23 IC-DISC Taxable Income (Enter smaller of Line 21 or Line 22)	47.50

Under the full costing CTI, the DISC taxable income is only $107.50 (50% of $200 full costing CTI + 10% of $75 export promotional expenses). MC CTI produced a higher DISC taxable income of $132.50.

6. **Example 2** – MC rules Application of no loss rule.

1. Facts:

	Domestic	Export
Sales	$1,000	1,000
Cost of Sales (Direct Exp)	400	600
Other expenses	200	390
Taxable income	400	10

2. The Schedule P (Rev. 12-2008) of the DISC will look as follows:

Part I - Section A-1 – Schedule P		
	Amount	**Return**
Line 1 QER Line	1,000	R-S
2a Cost of Sales	600	R-S

Part I - Section A-1 – Schedule P		
Line 2b R-S Expenses	100	R-S
Line 2c DISC Exp. Prom. Exp.	100	DISC
Line 2d Other DISC Exp.	190	DISC
Line 2e Add 2a-2d	990	
Line 3 CTI (full costing)	10	
Part I – Section A-2 - Schedule P		
Line 4 QER	1,000	
Line 5a Direct Material	400	
Line 5b Direct Labor	200	

Part I - Section A-1 – Schedule P		
Line 5c Exp. Prom. Exp	100	
Line 6 CTI b/4 OPPL	300	
Line 7 Sales For. & Dom	2,000	
Line 8a COGS	1,000	
Line 8b Exp (R-S & DISC)	590	
Line 9 Full Costing CTI	410	
Line 10 OPP (Line 9 /Line 7)	20.5%	
Line 11 OPPL (Line 4 X Line10)	205	
Line 12 MC CTI (Smaller Line 6 or Line 11)	205	

Part I - Section B - Schedule P	
Line 13 CTI (Line 3 or Line 12)	10.00
Line 14 (Line 13 X 50%)	5.00
Line 15 10% Exp Prom Exp	10.00
Line 16 Add Lines 14 and 15	15.00
Line 17 IC-DISC Taxable Income Enter smaller of Line 13 or Line 16	10.00
Part 1 - Section C – 4 % of QER	
Line 18 QER (Line 1)	1,000.00
Line 19 Multiply line 1 by 4%	40.00
Line 20 Multiply line 2c by 10%	10.00
Line 21 Add Lines 19 and 20	50.00
Line 22 CTI	10.00

Part I - Section B - Schedule P	
Line 23 IC-DISC Taxable Income (Enter smaller of Line 21 or Line 22)	10.00

3. Note – No loss rule of Treas. Reg. § 1.994-2(d) limited the CTI method to a maximum CTI equal to the lower full costing CTI.

7. **Example 3** – MC rules cannot be applied where there is no CTI

1. Facts

Part I -Section B – Schedule P	
FTGR	$10,000
Cost of Sales	650
Combined Gross Income	350
Less Expenses:	
Expenses of R-S	254
Expenses of DISC	100
CTI- loss	(4)

2. MC does not apply where there is no CTI. In this fact pattern, the DISC can recover its expenses by charging a commission of $100. The loss of $4 will appear on the tax return of the R-S.

10. Grouping and IRC § 994

1. Generally, the determination of DISC taxable income under IRC § 994 is to be made on a transaction by transaction basis. However at the annual election of the taxpayer (demonstrated by checking the appropriate box on Form 1120 IC-DISC Schedule P) some or all of the computations of DISC taxable income may be made on the basis of groups consisting of products or product lines. [62]
2. The regulations indicate that the taxpayers determination as to a product or product line will be accepted if it complies with any of the following standards:

1. A recognized industry or trade usage; or
2. The 2- digit major groups (or any inferior classification or combination thereof, within the major group) of the Standard Industry Classification as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President.
3. **See Napp Systems, Inc. v. Commissioner**, T.C. Memo 1993-196 (1993). The taxpayer calculated their DISC commissions using a country-by-country grouping. The court rejected the taxpayer's grouping because it violated Treas. Reg. § 1.994-1(c)(7), which only allows grouping transactions by product or product line.
4. A choice by the taxpayer to group transactions for a taxable year on a product or product line basis shall apply to all transactions within the product or product line consummated during the taxable year. However, the choice of a product or product line grouping applies only to transactions covered by the grouping and, as to transactions not encompassed by the grouping, the determinations are made on a transaction by transaction basis. For example, the taxpayer may choose a product grouping with respect to one product and use the transaction-by-transaction method for another product within the same taxable year. [63]
5. Grouping rules for services.

1. General Background. IRC § 993 provides that the DISC can have income from services in the following three situations:

1. Services which are related and subsidiary to any qualified sale, exchange, lease, rental, or other disposition of export property.
2. Engineering or architectural services for construction projects located (or proposed for location) outside of the U.S.
3. Managerial services in furtherance of production of other QER of an unrelated DISC.
2. The rules for grouping of services are at Treas. Reg. § 1.994-1(d)(3)(i) and (ii).

1. Related and subsidiary services, which are booked in the same year as the export property, can only be grouped with the sale and/or lease to which they relate.
2. Related and subsidiary services, which are NOT booked in the same year as the export property, can be grouped with the products or product lines to which the services are related, so long as the grouping of services chosen is consistent with the grouping of products or product lines for the taxable year the export property was sold, or in which payment for services is received or accrued.
3. Service income from engineering or architectural services is treated on a transaction-by-transaction basis.
4. Service income from a DISC rendering managerial services to an unrelated DISC is treated on a transaction-by-transaction basis.

6. Grouping per the Marginal Costing Rules

1. The rules for grouping under the MC rules are at Treas. Reg. § 1.994-2(c)(3).

1. Generally, the grouping rules used for full costing CTI apply to MC.
2. However, to compute the OPP, any product or product line grouping permissible under Treas. Reg. § 1.994-1(c)(7) may be used, even though it is NOT the same grouping used in determining MC CTI, so long as the grouping chosen for determining the OPP is at least as broad as the grouping in determining MC CTI.

1. This means that on the Schedule P, the grouping used to compute the OPP on lines 4 to 10 of the Schedule P, must be at least as broad as the grouping used to compute the MC CTI on lines 4 to 6 of the Schedule P.

11. Taxation of the DISC Shareholder

1. In general - Treas. Reg. § 1.995-1 provides –

1. A corporation which is a DISC for a taxable year is not subject to any tax imposed by subtitle A of the Code for the taxable year, except for the tax imposed by chapter 5 thereof (IRC §§ 1491 through 1494) on certain transfers to avoid tax. [64]

The shareholders of a DISC, or a former DISC, are subject to taxation on the earnings and profits of the DISC by way of distributions from the DISC in accordance with the provisions of chapter 1 of the Code generally applicable to shareholders, but subject to the modifications provided in IRC §§ 995, 996, and 997. [65]

There are three divisions of earnings and profits of a DISC, or former DISC from which distributions to shareholders may be made [66]:

- accumulated DISC income,
- previously taxed income, and
- other earnings and profits.

Whether or not, and to what extent, those distributions are taxable to the shareholder will be based upon from which division of E&P the distribution is considered to have come.

2. "Accumulated DISC income" is the earnings and profits of the DISC which have not been deemed distributed and which may be deferred from taxation so long as they are not actually distributed with respect to its stock. [67] However, deferral of taxation on "accumulated DISC income" may be terminated, in whole or in part, in the event of:

1. Certain foreign investment attributable to producer's loans (See Treas. Reg. §§ 1.995-2(a)(5) and 1.995-5);
2. Revocation of the election to be treated as a DISC or other disqualification (See Treas. Reg. § 1.995-3); and
3. CCertain dispositions of DISC stock in which gain is realized (See Treas. Reg. § 1.995-4).
2. Under IRC § 995(b)(1) and Prop. Treas. Reg. § 1.995-2A, each shareholder of a DISC is treated as having received a distribution (i.e., a deemed distribution) taxable as a dividend with respect to the shareholder's stock on the last day of each taxable year of the DISC an amount equal to the shareholder's pro rata share of the sum of the following items:

1. The gross interest derived by the DISC during the year from producer's loans.
2. The lower of —

1. Any gain recognized by the DISC during the year on the sale or exchange of property (other than property which in the hands of the DISC is a qualified export asset) which was previously transferred to it in a transaction in which the transferor realized gain which was not recognized in whole or in part, or
2. The amount of the transferor's gain not recognized on the previous transfer of the property to the DISC.

1. Each item of property in (1) & (2) above is to be considered separately.
3. The lower of —

1. Any gain recognized by the DISC during the year on the sale or exchange of property which in the hands of the DISC is a qualified export asset (other than stock in trade or property described in IRC § 1221(1)) and which was previously transferred to the DISC in a transaction in which the transferor realized gain which was not recognized in whole or in part, or
2. The amount of the transferor's gain which was not recognized on the previous transfer of the property to the DISC and which would have been includible in the transferor's gross income as ordinary income if its entire realized gain had been recognized upon the transfer.

1. Each item of property in (1) & (2) above is to be considered separately.

4. Fifty percent (50%) of the taxable income of the DISC for the taxable year attributable to military property. [68] Treas. Reg. § 1.995-6 provides rules for calculating taxable income attributable to military property.
5. The taxable income of the DISC for the taxable year attributable to QER of the DISC for such year which exceed $10,000,000.
6. In the case of a shareholder which is a C corporation, the sum of the following:

1. An amount equal to one-seventeenth (1/17) of the excess, if any, of the taxable income of the DISC for the taxable year, before reduction for any distributions during the year, over the sum of the amounts deemed distributed in (a) through (e) above.
2. An amount equal to 16/17 of the excess of the taxable income of the DISC for the taxable year, before reduction for any distributions during the year, over the sum of the amounts deemed distributed in (a) through (e), multiplied by the international boycott factor determined under IRC § 999(c)(1), or
3. In lieu of the amount determined in 2 above, 16/17 of such excess as is described in IRC § 999(c)(2).
7. In the case of a shareholder which is not a C corporation —

1. An amount equal to all of the excess of the taxable income of the DISC for the taxable year, before reduction for any distributions during the year, over the sum of the amounts deemed distributed in (a) through (e) above, multiplied by the international boycott factor as determined under IRC § 999(c)(1), or
2. In lieu of the amount determined (a) above, the amount of the excess as is described in IRC § 999(c)(2), and
8. An amount equal to the sum of any illegal bribes, kickbacks, or other payments paid by or on behalf of the DISC directly or indirectly to an official, employee, or agent in fact of a government.

1. An amount is paid by a DISC where it is paid directly or indirectly by any officer, director, employee, shareholder, or agent of the DISC for the benefit of such DISC.
2. The principles of IRC § 162(c) and the regulations thereunder shall apply.
3. The amount of an illegal payment made in the form of property or services shall be considered to be equal to the fair market value of such property or services at the time such property is transferred or such services are performed.
4. The amount of foreign investment attributable to producer's loans of the DISC, as of the close of the “group taxable year” ending with the taxable year of the DISC, determined in accordance with Treas. Reg. § 1.995-5. Please refer to the regulations under Treas. Reg. § 1.995-5 for rules on how to determine the foreign investment attributable to producer’s loans.

1. The amount of the foreign investment attributable to producer's loans determined for any taxable year of a former DISC shall be deemed distributed as a dividend to the shareholders of the former DISC on the last day of the taxable year.

2. See Treas. Reg. § 1.995-3(e) for the effect that the deemed distribution has on scheduled installments of deemed distributions or accumulated DISC income under Treas. Reg. § 1.995-3(a) upon disqualification.
3. Deemed distributions a) through h) immediately above are considered distributed pro rata to the shareholders of the DISC as a dividend and as a dividend they are taxable to the extent of the E&P of the DISC.
4. Deemed distribution i) above (foreign investment attributable to producer's loans) is distributed pro rata to the shareholders of the DISC as a dividend however it shall not exceed the lesser of the DISC's accumulated DISC income at the beginning of the year or the corporation's accumulated earnings and profits at the beginning of the year (but not less than zero) —

1. Increased by any DISC income of the corporation for the year as defined in Treas. Reg. § 1.996-3(b)(2) (that is, any excess of the DISC's earnings and profits for the year over the sum of the amounts determined in a) through h) above, or
2. Decreased by any deficit in the DISC's earnings and profits for the year.

1. Example 1: A DISC has a deficit in accumulated earnings and profits at the beginning of a taxable year of $10,000, current earnings and profits of $12,000, no deemed distributions from any of the other deemed distributions above for the year, and foreign investment attributable to producer's loans for the taxable year of $5,000. The DISC would have a deemed distribution of $5,000 for the taxable year (the lesser of the actual foreign investment attributable to producer's loans of $5,000 or the smaller of 1) the accumulated DISC income at the beginning of the year of ($10,000) or 2) the corporation's accumulated earnings and profits at the beginning of the year (not less than $0), increased by DISC's income for the year of $12,000). [70]
2. Example 2 - assume that the DISC had accumulated earnings and profits of $13,000 at the beginning of the taxable year, accumulated DISC income of $10,000 at the beginning of the taxable year, a deficit in earnings and profits for the taxable year of $12,000, no other deemed distributions for the taxable year, and foreign investment attributable to producer's loans for the taxable year of $5,000. Under these facts the DISC would have no deemed distribution for the taxable year because the DISC had no DISC income for the taxable year and the current year's deficit in earnings and profits subtracted from the DISC's accumulated DISC income at the beginning of the year produces a negative amount. [71]
3. For rules relating to the carryover to a subsequent year of the $5,000 of foreign investment attributable to producer's loans. See Treas. Reg. § 1.995-5(a)(6).
4. Prop. Treas. Reg. § 1.995-2A(b)(3) addresses the order of the deemed distributions when the DISC lacks sufficient E&P.

1. If the deemed distribution is limited by the E&P and therefore causes less than the full sum of the amounts that would otherwise be considered a deemed distribution to be

reported, then the portion of the limited sum which is deemed distributed is to be considered as attributed first to the first item described as a deemed distribution under IRC § 995(b)(1) to the full extent thereof; next to the second item described under IRC § 995(b)(1) to the full extent thereof; and so forth, until the deemed distribution has been accounted for.

2. Examples of how this works can be found in Prop. Treas. Reg. § 1.995-2A(c).
9. Prop. Treas. Reg. § 1.995-2A(d) provides special rules concerning certain tax free acquisitions of property by a DISC. m) Prop. Treas. Reg. § 1.995-2A(e) provides rules concerning how to treat carrybacks of NOL's and capital losses to prior DISC's taxable year.
5. Distributions upon disqualification –

1. IRC § 995(b)(2) provides the consequences to a shareholder when a DISC election is revoked or the DISC failed one or more of the requirements to qualify as a DISC.

1. A shareholder of a DISC, that either revoked its election to be a DISC or failed to satisfy one or more of the requirements to be a DISC, will be deemed to have received in equal installments in each of the next ten years (or number of immediately preceding consecutive taxable years corporation was a qualified DISC if less) beginning after the year of disqualification an amount equal to the shareholder's pro rata share of the accumulated DISC income. [72] The deemed distributions are taxable as dividends. [73]

1. The pro rata share is determined as of the end of the last taxable year that the DISC was a qualified DISC.
2. For example, a calendar year corporation elects to be a DISC effective 1/1/01. The DISC accumulates $10,000 of accumulated DISC income. Effective 1/1/06, the DISC revokes its DISC election. Under Treas. Reg. § 1.995-3(b), the DISC will be deemed to receive in equal installments $2,000 on the last day of each of the five following tax years (12/31/06 through 12/31/10).
2. The deemed distributions upon disqualification will be includible on the shareholder's return only as long as the shareholder holds the shares with respect to which the distributions are deemed made. If the shares are transferred than the transferee will include the remaining deemed distributions. In other words the reporting of the deemed distributions upon disqualification follow the stock not the stock holder at the time of disqualification. [74]

1. Exception – if the transferee acquired the shares in a transaction in which the transferor's gain is treated in whole or in part as a dividend under Treas. Reg. § 1.996-4(a) then the transferee does not have to include the subsequent installments as coming from accumulated DISC income. Instead the subsequent installments will be treated as coming from previously taxed income. [75]

3. A deemed distribution paid as part of a disqualification continues and is included into income by the shareholder even if the DISC subsequently requalifies and is again treated as a DISC. [76]
4. If a shareholder receives an actual distribution out of accumulated E&P or a foreign investment attributable to a producer loan deemed distribution during the same period that the shareholder is taking into account a disqualification deemed distribution, then the actual distribution, to the extent it is from accumulated DISC income will be reported in the year received as a dividend and will reduce the last installment scheduled and then the preceding scheduled installment in reverse order until it is fully absorbed. [77]
5. Treas. Reg. § 1.995-3(f) provides examples that illustrate the distribution upon disqualification rules.
6. Treas. Reg. § 1.995-4 provides the general rules on how to handle the gain from dispositions where a shareholder disposes of, or is treated as disposing of the stock in the DISC.

   Disposition of corporate stock generally results in gain recognition unless a non-recognition provision applies.

1. Dispositions where gain is recognized – any gain recognized will be included as a dividend to the shareholder to the extent of the DISC's accumulated DISC income. Any excess of the gain recognized over the accumulated DISC income will be treated as gain from the sale or exchange of stock. [78]
2. Dispositions where gain is not recognized – there will be no distribution from accumulated DISC income for gain realized but not recognized. [79]
3. Treas. Reg. § 1.995-4(b) provides rules concerning dispositions in which separate corporate existence of the DISC is terminated. Notwithstanding any other provision of the Code, an amount of realized gain shall be recognized and included in the transferor's gross income as a dividend. The realized gain shall be recognized to the extent that such gain – 1) would not have been recognized but for the provisions of this paragraph, and 2) does not exceed the accumulated DISC income amount (described in bullet (e) below).
4. Treas. Reg. § 1.995-4(c) provides rules concerning dispositions to which IRC §§ 311, 335, or 357 apply. An amount equal to the excess fair market value of such stock over its adjusted basis in the hands of the shareholder shall, notwithstanding any other provision of the Code, be included in gross income of the shareholder as a dividend to the extent of the accumulated DISC income amount (described in bullet (e) below).
5. Accumulated DISC income for these purposes is defined as the accumulated DISC income that is attributable to the stock of the DISC which was disposed and which was accumulated during the period the stock was held by the shareholder who disposed of the stock. [80]
7. As previously mentioned in this guide, the DISC defers the taxable income attributable to the first $10 million of QER. The amount of QER that exceeds this deferred portion must

be reported as a deemed distribution. This excess does not cause the DISC to be disqualified. [81]

1. Generally, DISCs in the same controlled group of corporations [82] must share the $10 million amount equally among the member DISCs.

1. In lieu of an equal allocation of the $10 million amount, all of the member DISC's may consent to an unequal allocation.

1. The consent must be signified by a statement that satisfies the requirement of and is filed in the manner prescribed by Treas. Reg. § 1.1561-3.
2. The plan may be amended as provided by Treas. Reg. § 1.995-8(f)(1). Please see this provision for the exact rules.
2. If the DISC year is a short year the $10 million must be prorated. [83]
3. If the DISC has QER that exceeds $10 million then it must segregate those QER into two amounts, those that are to be considered not to exceed $10 million and those that do exceed $10 million. Except as provided in Treas. Reg. § 1.995-8(b)(2) & (3)(described in sub-bullets (1) and (2) below), the allocation of the QER is solely at the discretion of the DISC as long as such allocation is made by the DISC on or before the due date of the DISC's return for the taxable year. [84] The allocation of the $10 million amount may be amended under certain conditions set forth in Treas. Reg. § 1.995-8(b)(1).

1. Exception 1- Related and subsidiary services must be allocated along with the sale or lease to which they are attributable. [85]

1. For example if the DISC has a $100 sale of which $8 is made up of related and subsidiary services the full sale price of $100 must be either in the amount that exceeds or does not exceed the $10 million they may not be separated.
2. Exception 2 – When the last transaction selected causes the DISC to exceed the $10 million dollar QER that transaction may be bifurcated with the amount of QER of the transaction that do not cause the DISC to exceed the $10 million going into the does not exceed amount and the balance going into the exceeds amount. [86]
4. After identifying the transactions that are considered to exceed the $10 million amount, the DISC will reduce the excess receipts by COGS attributable to those receipts, and the deductions expenses and losses properly allocated and apportioned to those receipts in accordance with Treas. Reg. § 1.861-8. [87]
8. The "IC" in IC-DISC stands for interest charge. The interest charge was instituted in 1984 under IRC § 995(f). This provision requires that each shareholder pay an interest charge on the shareholder's **DISC-related deferred tax liability** at a base period **T-bill rate**.

1. The interest charge is computed on Form 8404. [88]
2. The interest charge:

1. Is an annual charge and is imposed on the shareholder and not on the DISC.

2. Is treated as interest paid or accrued on an underpayment of tax.
3. Does not increase or decrease the shareholder’s basis in the stock of the DISC and it does not increase or decrease the taxable income or the E&P of the DISC. [89]
3. The interest charge is equal to the product of –

1. The shareholder’s DISC related deferred tax liability for the year multiplied by,
2. A factor which is equal to the base period T-bill rate [90] compounded daily for the number of days in the shareholder’s taxable year for which the interest charge is being computed. [91]
4. DISC related deferred tax liability is the cumulative amount of the income tax that is considered to have been deferred from taxation in prior taxable years. [92]

1. Under IRC § 995(f)(2), the shareholder's DISC-related deferred tax liability, with respect to any taxable year of a DISC shareholder ending after 1984, is the excess of —

1. The amount which would be the tax liability of the shareholder for the taxable year if the amount of the deferred DISC income of the shareholder for the taxable year were included in the shareholder's gross income as ordinary income, over
2. The actual amount of the shareholder's tax liability for the taxable year.
2. Deferred DISC income means the excess of –

1. The shareholders pro rata share of the DISC accumulated DISC income as of the close of the computation year, over
2. The amount, if any, of the distributions in excess of the income made by the DISC during the taxable year of the DISC immediately following the computation year.

1. The computation year is the taxable year of the DISC ending with (or within) the taxable year of the shareholder which precedes the taxable year for which the amount of the deferred DISC income is being determined.
3. Example illustrating the computation year - assume the following:

1. A DISC has two shareholders,

1. A, the principal shareholder (calendar year taxpayer), and
2. B, a minority shareholder (fiscal year ending June 30 taxpayer).
2. Under IRC § 441(h), the DISC must use the calendar year as the taxable year.
3. In determining the amount of shareholder A's deferred DISC income for A's taxable year ending December 31, 2007, the computation year is the DISC's taxable year ending December 31, 2006, that is, the taxable year of the DISC ending with shareholder A's taxable year preceding the taxable year of A for which A's deferred DISC income is being determined.
4. In determining the amount of shareholder B's deferred DISC income for B's taxable year ending June 30, 2007, the computation year is the DISC's taxable year ending December

31, 2005, that is, the taxable year of the DISC ending within B's taxable year preceding the taxable year of B for which B's deferred DISC income is being determined.

3. If in the taxable year the shareholder owns stock in more than one DISC, the deferred DISC income of that shareholder for the taxable year is the sum of the amounts of deferred DISC income of the shareholder with respect to each of the DISCs. [94]
4. Where the DISC shareholder is a member of an affiliated group of corporations that files a consolidated return, the affiliated group's DISC-related deferred tax liability for the taxable year is the excess of (A) the amount which would be the group's tax liability including in gross income the deferred DISC income for the taxable year of each DISC shareholder which is a member of the group, over (B) the amount of the group's actual tax liability for the taxable year. [95]
5. Unless otherwise provided in Prop. Treas. Reg. § 1.995(f)-1(d) or (e), the computations necessary to determine the shareholder's DISC related deferred tax liability are to be made under the law and the rates of tax applicable to the shareholder's taxable year for which the computations are made. [96]
6. Prop. Treas. Reg. § 1.995(f)-1(j) provides rules concerning the manner and time for filing or amending Form 8404 and paying the interest charge.
5. The source of the deferred DISC income which is considered as included in the shareholder’s gross income for purposes the DISC related deferred tax liability is determined under Treas. Reg. § 1.861-3(a)(5) (U.S. source income) in the same manner as if it were actually distributed to the shareholder. [97]

11. Rules for actual distributions and certain deemed distributions.

1. The general rule is that any actual distribution to a shareholder by the DISC which is made from E&P will be treated as [98]:

1. First, coming from previously taxed E&P the extent thereof;
2. Second, coming out of accumulated DISC Income to the extent thereof; and
3. Third, coming out of other E&P to the extent there of.

2. Any actual distribution to meet qualifications requirements and any deemed distributions relating to foreign investments attributable to producer’s loans which are made from E&P will be treated as [99]:

1. First, coming out of accumulated DISC income to the extent thereof;
2. Second, coming out of other E&P to the extent thereof; and
3. Third, coming out of previously taxed income to the extent thereof.

3. Special rule for after 1984. —For taxable years beginning after December 31, 1984, in the case of a DISC shareholder which is a C corporation, the rules for actual distributions to meet qualifications requirements and any deemed distributions relation to foreign investments attributable to producer’s loans shall apply to 16/17 of the amount of an actual distribution made pursuant to Treas. Reg. §1.992-3 to satisfy the condition of

Treas. Reg. §1.992-1(b) (the gross receipts test) and the general rule above shall apply to one-seventeenth (1/17) of such amount. [100]

4. Under IRC § 996(a)(3) amounts distributed out of previously taxed income will be excluded by the recipient from gross income.
5. Distributions made during the year will be treated as being made in the following order[101]:

1. Deemed distributions (both normal deemed distributions and deemed distribution upon disqualification);
2. Actual distributions to meet qualifications in the order in which they were made; and
3. Other actual distributions in the order they were made.

5. How Do I Start the Audit

To audit the DISC, you must understand more than the concepts expressed above, regarding the applicable sections of the IRC. You must know the audit trail from the books and records of the DISC and R-S to the tax returns of the DISC and R-S.

It is common to become confused when reviewing a DISC return for the first time. A possible reason for the confusion is the numbers on the DISC return flow from the back of the return (Schedule P) to the front of the return. This is the reverse of most other returns.

1. Forms the DISC must file when it is formed, operates and is sold, liquidated or reorganized.

By definition the DISC is a domestic corporation. It usually is wholly owned by a U.S. corporation or individual. Usually when the DISC is formed, a U.S. person transfers property to it in an IRC § 351 transaction.

Below is a summary of the sections and reporting requirements that apply.

1. The DISC (or small DISC) must elect to be treated as a DISC (or small DISC), by filing a Form 4876A.

1. The election must be made within 90 days after the beginning of the first taxable year of a newly formed corporation or during the 90 days immediately preceding the beginning of the first taxable year to which the election applies.
2. The DISC must use the same tax year as that of its shareholder that owns the largest percentage of the voting power. IRC § 441(h)
2. The DISC return is Form 1120-IC-DISC. It is useful to read the instructions to the Form 1120-IC-DISC.
3. The Schedule P Form 1120-IC-DISC is used to calculate the intercompany transfer price or commission. You should obtain the audit trail from the taxpayer's books to the Schedule Ps. In order to accomplish this task, an understanding of what the taxpayer is required to provide on the Schedule Ps is required.

Each transaction or group of transactions, that generate QER generally requires a separate Schedule P to compute the CTI, the transfer price and income of the DISC.

1. The Schedule P provides:

1. Name of the DISC;
2. Employer identification number;
3. Identity of the product or product line reported on the schedule; and
4. Type of transaction: transaction-by-transaction or grouping of transactions.
2. The taxpayer may combine their transactions or groups of transactions on one Schedule P, provided that the taxpayer maintains supporting schedules for each transaction or group of transactions reported in the aggregate.

2. ***Review the prior IE reports and the historical file – If there has been an examination of this entity previously this is your starting point.***

3. ***Learn the taxpayer's business***

You should start by gaining an understanding of the R-S's and DISC's business. Questions that need to be asked include what is being sold and how, when, and where is it manufactured. Learn about the selling function and who purchased the products. This background will enable you to focus your attention on the portions of the regulations that apply to your case, and which expenses should be allocated to the QER.

Also note that Westlaw or Google search can assist with points 1 and 2 below.

1. To obtain general information about the taxpayer's business/industry consider:

1. Industry publications;
2. Industry guidelines, that may exist in the IRM;
3. c) The ISP program; and
4. Articles in trade publications
2. To obtain information about your specific taxpayer, consider:

1. Annual reports and 10Ks, for publicly traded companies;
2. Periodicals about the taxpayer and its business; and
3. Sales brochures and/or promotional material that describe the products.

4. ***Request the tax workpapers of both the R-S and the DISC.***

Typically, the DISC has a R-S and used the administrative pricing rules of IRC § 994. Most of the expenses incurred to generate the QER are on the books of the R-S. Often the books of the DISC contain the expenses that relate to export promotion expenses.

To prepare the Schedule P(s), the taxpayer has made a series of judgments as to which expenses should be allocated to the QER. The taxpayer probably started with an income statement of the R-S and decided whether or not to allocate and apportion expenses to the QER. You need to obtain the workpapers used in that process because they provide the trail from the R-S to the Schedule Ps.

You should be able to determine whether the Schedule Ps are on a transaction, product, or product line basis. If the taxpayer grouped, you should be able to determine which transactions are included in each grouping.

1. When the taxpayer prepared the Schedule P(s), it may have considered, some or all, of the items listed below:
1. Both the tax return and the taxpayer's books will contain detailed expense categories. Usually the expense categories on the tax return will not match the expenses listed in the taxpayer's books. The expenses on the Schedule P represent combinations of some of these expenses.
2. The taxpayer may have several divisions, but only one may have export sales.
3. The division with the export sales, may have several different broad product lines, only two of which may have export sales.
4. Each product line may be further broken down into sub-product lines. For example, a product line may have four products.
5. A product may be broken down into separate transactions.

Regardless of how many steps the taxpayer took, the taxpayer should have completed this process, before he filed the tax return(s). At this point you just want to be able to follow the trail to/from the books of the R-S and DISC to the CTI statement(s) on the Schedule P(s).

2. In many cases the taxpayers use a computer program to make the computations on the Schedule Ps. When a computer program is used, the workpapers that show the audit trail are sometimes referred to as the "documentation package."

5. Request internal accounting records of the taxpayer

1. Divisional Profit & Loss and Balance Sheets
2. Product line Profit & Loss and Balance Sheets

These records are typically kept on larger companies. You will have to determine what they are called. Often the accounting department has made judgments about which expenses should be applied to a given product line.

These statements are not on a tax basis, and may not consider every expense. For example, they might only allocate direct material and labor, and normal applied

overhead and only certain below the line expenses. However, they do show the accounting department's view of how expenses should be allocated on a book basis.

6. Determine whether the workpapers and QER information is on Machine Sensible format.

When the workpapers, and/or sales data are on machine sensible formats, you should review whether that information will be of assistance. Usually, the answer will be yes, and you will need the help of the CAS.

7. Review the Information described above.

Some of the broad concepts to keep in mind are listed below:

1. Are the workpapers, and Schedule Ps on a tax basis, not a book basis?
2. The taxpayer made a series of allocations regarding expenses. It allocated all, part, or none of a given expense to the QER. Are the allocations made on a reasonable basis? When no part of a material expense (or department) is allocated to QER, determine why. Do these allocations make sense in light of what you know about the taxpayer's business?
3. Are the allocations made in accordance with Treas. Reg. § 1.861-8?
4. Always consider the end result. If the QER shows a profit of 30% of sales, but similar products sold in the U.S. has a profit of 1%, determine the reason(s) for the difference.
5. Review the pricing rules of IRC § 994.

Most of the adjustments made by to the R-S return during the audit process can impact the CTI statements, the Schedule Ps, and the returns of the DISC and the R-S. As expenses are increased or decreased, there is more or less expense to allocate to CTI. Also, when income is increased or decreased, the gross income will change, which will also impact the expenses that were allocated to CTI on the basis of gross income.

5. Selected Issues

1. Export Property and Qualified Export Receipts

1. Introduction

As discussed above, these rules are complex, so often determining whether a taxpayer has complied is not easy. Ideally, you would start with all the relevant facts and then research whether the sales qualify as QER. However, you will rarely start with all of the relevant facts. As such, you should review the rules discussed in the outline above on export property and QER before you start your examination to better understand what facts are required. Then you can proceed to obtain the relevant facts through IDRs, interviews, or both. You will be able to eliminate or further develop the issues as facts are gathered.

The discussion below is intended to highlight some of the facts you will need to keep in mind. Listed below are some of the broad areas where you should obtain knowledge of the taxpayer's business and some of the issues that may exist. The list is not all inclusive, nor will every item listed be present in a given case.

2. Export Property

1. A description of the property sold.
    - Sales of military property receive 50% of the tax favored treatment that sales of other export property receive.
    - Most intangible property is not export property.
    - Most oil and gas products are not export property.
2. A description of the manufacturing process. This should include the following:
    - Who manufactured the property?
    - Where was the property manufactured?
    - Did the manufacturing process occur at more than one location?
    - What is the country of origin of the raw materials used to manufacture the property?
    - Did manufacturing occur after the property was sold and before it was exported from the U.S.?
    - Is more than 50% of the value from articles imported into the U.S.?
3. A description of the movement of the property from the place of manufacture to the customer.
    - Where was the property shipped from and who was the carrier?
    - What documents exist regarding shipment of the goods?
    - Did the goods leave the U.S. within one year?
    - Was the property subject to any further manufacturing, assembly, or other processing between the time of sale or lease and the delivery outside the U.S.? If so, consider General Electric, which was discussed earlier.
4. Who were the customers?
    - Sales to U.S. persons can qualify, but probably should be investigated.
    - Not all sales to the U.S. government qualify.
    - Did the U.S. government subsidize the sale?
    - Sales to related parties are subject to additional rules. The rules are summarized in the chart in bullet 4 below.
5. Did the property return to the U.S., or could it be expected to return to the U.S.?
6. Is the property disqualified from being export property per IRC § 993(c)(2)?

3. QER

1. Are the gross receipts from items listed in IRC § 993(a)?

2. Are the gross receipts excluded as QER by operation of IRC § 993(a)(2)?

2. Computation of CTI.

1. Does the end result suggest further analysis?

If you have followed the steps discussed above in Section IV, you will have:

- An understanding of the taxpayer's business,
- A definition of the product lines, products, and/or transactions on the Schedule Ps (this was discussed at III. I. above), and
- A complete trail from the books to the Schedule Ps.

As you review the records, ask yourself whether the end result complies with Treas. Reg. § 1.861-8 and if the end result makes sense. For example:

- The entire division had a profit of $10,000,000, but the sum of the profits on the CTI statements, total $9,000,000, when the export sales are less than 50% of total sales.
- The widgets sold in the U.S. have a bottom line profit of 5%, but when widgets are exported the bottom line profit is 40%.

The above does not mean you have an automatic adjustment, however, it does suggest a need for further analysis.

A few of the possible reasons are:

- When the taxpayer allocated expenses, certain categories of expense(s) were not allocated.
- When the taxpayer allocated expenses, certain categories of expense(s) were allocated on an unreasonable basis.
- The product mix is different. For example, spare parts are more profitable and most of the exports were of spare parts.
- The items listed in items 2 to 9 below.

2. Is there a distortion of income that impacts the computation of CTI?

This issue was discussed in **General Dynamics Corps. v. Commissioner**, 108 T.C. 107 (1997). In General Dynamics Corps, the taxpayer accounted for long-term contracts on the completed contract method. Though normally income and expenses connected with long-term contracts are not reported or claimed until the completion of the contract, the taxpayer may elect to currently deduct certain period expenses. In computing CTI, the taxpayer excluded the certain period expenses deducted prior to completion of the contract. The court held that taxpayer must account for all related costs, including period costs, of both current and prior years in determining their

CTI. The court provided that requiring taxpayer to account for all period costs in determining CTI is consistent with the completed contract method of accounting.

To numerically illustrate **General Dynamics Corps** please consider the following example. Assume that a taxpayer incurs $100 of period costs on a 3 year construction contract. The period costs are incurred $40 in year 1, $30 in year 2 and $30 in year 3. The taxpayer uses the completed contract method of accounting; the sale is booked in year 3. Assume that 40% of the total sales contract generated qualified QER.

In the context of the facts above, the taxpayer argued that only the year 3 period costs should be allocated to CTI, so the taxpayer allocated (40% of $30) $12. The court held that taxpayer's method resulted in a distortion and allocated (40% of $100) $40 to the CTI.

3. How were research and development ("R&D") expenses allocated? The allocation of R&D to CTI during the early DISC years was a subject of litigation. The dispute involved the allocation of R&D regulations at Treas. Reg. § 1.861-17 (previously located at Treas. Reg. § 1.861-8(e)(3)), which required that R&D expenses be allocated to income on the basis of SIC codes. Treas. Reg. § 1.994-1(c)(6)(iv) permits CTI to be computed on the basis of income of products or product lines. The Service argued and the Supreme Court agreed in **Boeing Co v. United State**s, 537 U.S. 437 (2003) that Treas. Reg. § 1.861-17 determines the allocation of R&D expenses to income for purpose of calculating CTI.

   Boeing Co. v. United States abrogates **St. Jude Medical, Inc. v. Commissioner**, 34 F.3d 1394 (8th Cir. 1994).

   Boeing manufactures commercial airliners. Its product lines include the 707, 727, 737 etc. The taxpayer divided its R&D into two broad categories: Blue-Sky and company sponsored product development which includes product-specific research. Erroneously relying on Treas. Reg. § 1.994-1(c)(6), the taxpayer treated all of the company sponsored product development research as directly related to a single program, and as totally unrelated to any other program. For example, in taxpayer's calculation of CTI, the cost of R&D directly related to the 767 model had no effect on the calculation of the CTI produced by export sales of the other models.

   The Supreme Court noted that Treas. Reg. § 1.994-1(c)(6) allows the taxpayer to choose to group export receipts and the regulation establishes that there shall be an allocation and apportionment of all relevant costs deducted in the taxable year. The court held, however, that Treas. Reg. § 1.994-1(c)(6) "does not speak to how costs should be allocated among different items or classes of gross income and apportioned between the DISC and [the R-S] once the taxpayer groups its gross receipts. The court provided that Treas. Reg. § 1.861-8(e)(3) "fills this gap by providing that R&D expenditures that are related to all income reasonably connected with the taxpayer's

relevant two-digit SIC category or categories are ‘allocable to all items of gross income as a class… related to such product category (or categories).’”

For a numerical illustration please assume that the 727 was a new product line that did not generate any sales until year 3. Further assume that 60% of the year 3 sales were exported. In years 1 to 3, the Program R&D expenses for the 727 were $100 a year. The $100 of Program 727 R&D expenses in years 1 and 2 should be allocated to all sales (for all product lines) not just sales of the 727 product line.

4. R&D expenses allocated to CTI are **not** reduced by the portion of the R&D subject to exclusive geographic apportionment.

Quick overview of Treas. Reg. § 1.861-17
R&D like other deductions is first allocated and then apportioned. The first step is to allocate R&D to product categories based upon the 3 digit SIC code [105]. The second step is to apportion R&D between the statutory and residual grouping.

Once the R&D is allocated to a product category it is then apportioned under either the sales method or the gross income method. Each of those methods apportion a fixed percentage of the R&D to the geographic source where most of the R&D was performed. For most U.S. corporations, the portion of the R&D subject to the geographic source rule will be allocated to U.S. source income, since typically the R&D is performed in the U.S.

However, the CTI calculation is not based upon whether the QER generate U.S. source income or foreign source income. So the R&D subject to the exclusive geographic apportionment should reduce CTI. This concept was discussed in Rev. Rul. 86-144.

For example, assume:

- The R&D assigned to a product category is $1,000.
- 60% of the sales in that product category generate QER.
- The taxpayer can use the sales method and $500 is allocated to U.S. source income to the determine the foreign source income.

The R&D allocated to CTI would be 60% of $1,000 or $600.

5. Were interest income and interest expense netted?

The issue here is whether when allocating interest expenses to CTI, must the taxpayer allocate the interest expense (without any offset) or can it allocate the net of the interest income and interest expense.

Bowater v. Commissioner, 108 F.3d. 12 (2d Cir. 1997), **rev’g.**, 101 T.C. 207 (1993), **cert. denied**, 118 S. Ct. 689 (1998). The Second Circuit reversed a Tax Court

decision which had allowed the taxpayer to allocate the net interest expense. The Second Circuit stated that the plain language of Treas. Reg. § 1.861-8(e)(2) controls and that this regulation requires the interest expense be allocated on a gross basis in computing CTI. In other words, the aggregate of deductions for interest must be allocated ratably to interest income on the same basis as if it allocated to all other income producing activities. The Second Circuit also said, “the tax Court had it right the first time [in its 1989 decision in **Dresser**, which was later reversed by the Fifth Circuit,] and we reverse its decision [in **Bowater**] for the taxpayer.” Note that Treas. Reg. § 1.861-8(e)(2) was replaced by Treas. Reg. § 1.861-8T(e)(2), which refers you to Treas. Reg. §§ 1.861-9T through 13T. However, since Treas. Reg. § 1.861-9T(a) requires gross interest expense amount be allocated to all sources of income, this holding will still apply.

The **Dresser** Cases
There is more than one **Dresser** case

In **Dresser Industries Inc. v. Commissioner**, 911 F.2d 1128 (5th Cir. 1990), the 5th Circuit allowed taxpayer to net interest income and interest expense. Treas. Reg. § 1.861-8 was later revised in 1977 and supersedes this case as discussed in the later Dresser Industries case below.

In **Dresser Industries, Inc. v. United States**, 73 F. Supp 2d 682 (N.D. Tex. 1999), **aff'd**, 238 F.3d 603 (2001). Dresser filed a refund claim for the 1981 to 1987 tax years. One of the issues involved the netting of interest income and expenses for the purposes of calculating CTI. The District Court held that “Dresser is not entitled to net gross interest income against gross interest expense in computing the combined taxable income of its DISC and related supplier for the 1984 and 1985 tax years,” based upon the 1977 amendments to Treas. Reg. § 1.861-8(e)(2).

6. Were accounts receivable factored by a R-S?

   If a R-S factors receivables from export property at a discount, then the discount reduces the QER for purposes of computing DISC profits under the administrative pricing methods of 4% of QER and 50% of CTI. **See** Temp. Treas. Reg. § 1.924(a)-1T(g)(7).

7. Were there losses?

   TD 8805 issued, January 11, 1999, contains final and temporary regulation regarding the “Allocation of Loss With Respect to Stock and Other Personal Property; Application of Section 904 to Income Subject to Separate Limitations”.

Generally, the effective date of the regulations is January 11, 1999. However, the taxpayer may elect to apply these rules to tax years beginning on or after January 1, 1987. If a taxpayer allocates a loss, you need to know the applicable regulation(s). It is suggested you start with the Supplemental Information contained in TD 8805, to find the answer.

Treas. Reg. § 1.861-8(e)(8) provides that a NOL deduction allowed under § 172 shall be allocated and apportioned in the same manner as the deductions giving rise to the NOL deduction.

Keep in mind the Treas. Reg. § 1.994-1(e)(1) no loss rule discussed above.

8. How are currency gains and losses allocated to CTI?

1. The position in FSA 199935008 is the losses on the forward sale of foreign currency should be allocated pursuant to sections Temp. Treas. Reg. §§ 1.925(a)-1T(d)(2)(iii) and 1.925(a)-1T(c)(6)(iii)(D) to combined gross income. Also, currency gains from hedging by forward contracts constitute FTGR in the same manner as the underlying export property. This FSA relates to FSC, however the analysis is under Treas. Reg. § 1.861-8, which also applies to DISCs.
9. If the taxpayer used standard costs to determine its cost of sales, be sure that any variances are also allocated to the QER.

3. **Grouping**

The following example [106] illustrates the steps a taxpayer would take if it uses grouping to prepare the Schedule P(s) of the DISC. The audit steps and issues are discussed in the context of this example.

Example

A taxpayer's business is the design, manufacture, and sale of different kinds of containers. The containers store: steel pellets, medical waste, and nuclear fuel. Each of these product lines contains 2 products. Some of the receipts qualify as QER.

Because the taxpayer has QER, it must decide how to place the QER on the Schedule P(s) of the DISC. At this point, the taxpayer must answer two questions:

1. What is a product or product line?
2. Can the taxpayer construct a CTI statement from its books and records for the product or product line?

Question 1: Product or Product Line

The first question is answered by applying the SIC Codes or recognized trade or industry usage standard as specified by Treas. Reg. § 1.994-1(c)(7)(ii). The taxpayer's products or product lines are listed below.

- Level 1 Entity. Container business.
- Level 2 Product Line. Steel pellets, medical waste, and nuclear fuel containers.
- Level 3 Product. The containers are made in two sizes. The containers from one product line can be substituted for one in another product line.
- Level 4 Individual transactions.

This is illustrated in the chart attached. (pdf, 11KB)

Question 2: Construction of CTI Statement

The second question is answered by a review of the taxpayer's books and records. The taxpayer can prepare income statements for each of the 4 levels. All of the income statements can track the specific sales, direct material costs, direct labor costs, normal applied overhead, and inventory. The below the line expenses are allocated by the tax department. Assume the income statements are on a full costing tax basis and are in accordance with Treas. Reg. § 1.861-8.

When you audit the DISC, you are going to have to retrace these steps. With this in mind, a discussion of certain audit steps and issues follows.

1. What are the taxpayer's definitions of a product, product line, and transaction?

1. Ask the taxpayer to state its definition of a product, product line or transaction. See if the definition conforms to definition under Treas. Reg. § 1.994-1(c)(7). You must know what products are included in each Schedule P and the groupings used on each Schedule P. A format similar to the chart above –or the equivalent—will help.
2. Since each product, product line or transaction is on a separate Schedule P, obtain the audit trail from the books to the Schedule Ps. The audit trail should identify whether all of the expenses have been included.
3. For sub-bullets a) and b) above, consider the use of the Computer Audit Specialist when the data is in a machine sensible format.
4. In this example, assume the above chart satisfies the definition of a product line, product, or transaction.

2. Review the data obtained in 1 above.

   What is acceptable and not acceptable, in the context of the above example, following the FSC guidance is discussed below.

1. The taxpayer can prepare the Schedule Ps as follows:

   - Level 1 Entity—One Schedule P. Total of all 82 export transactions.

- Level 2 Product Line. Three Schedule Ps: Steel (total of 12 export sales), medical (total of 30 export sales) and nuclear (total 40 export sales).
- Level 3 Product. Six schedule Ps. For example steel pellets would have 2 schedule Ps: Product A (total of 10 export sales) and product B (total of 2 export sales). The same idea would apply to medical and nuclear, each of which would have two products.
- Level 4 Separate transactions. Eighty-two separate Schedule Ps for each export sale.

2. Any of the following would **not** be allowed:

   - Consider product A, at level 3 in the steel pellet product line. If the taxpayer placed product A on a separate Schedule P, it cannot prepare a schedule P for:
   - The steel pellets product line, or
   - For the entire entity.

     Both of these are example of where the same product, product A, was used in more than one Schedule P.
   - The taxpayer cannot prepare a Schedule P consisting of a combination of product A, M and X. It has not included all products and transactions in the product line. There is no justification for this combination.
   - The taxpayer cannot prepare a Schedule P with a combination of steel pellets with medical waste, and ignore nuclear fuel. All of level 2, not selected product lines of level 2.
   - Any combination based solely on its computer program's ability to maximize FTI. The group must be based upon SIC or recognized industry trade and usage.

     Note: In 1997, the SIC codes were replaced by the North American Industry Classification System ("NAICS") codes.

3. Grouping and Marginal Costing:

   The grouping rules for MC involve the computation of the Overall Profit Percentage Limitation ("OPPL"). [107] For purposes of the MC OPPL, the grouping must be at least as broad as the one used to compute the full costing CTI. The MC rules were discussed at III. H.

   1. Example of what would be acceptable:
      Consider the 10 export transactions for product A. Assume that the taxpayer places the first 9 on separate Schedule Ps. The 10th transaction has a full costing profit of 1%. To compute the OPPL for the 10th transaction, the taxpayer can use either:

      - All 50 transactions for product A,

- The sum of all of the transactions in product A (50 transactions) plus product B (5 transactions), or
- All 455 transactions of the entire container division.

  Note: The MC no loss rule prevents the profit on the 10th product from exceeding the full costing CTI, which is 1% in this fact pattern.

2. Example of what would NOT be acceptable. The taxpayer used MC for steel pellets. The OPPL consisted of all 55 transactions. Now it wants to use MC for product M in medical. Taxpayer is limited to either:

   - The 100 transactions in product M, or
   - The 200 transactions in medical.

     He cannot use all 455 transactions, because that group includes steel, which cannot again be used.

3. Another example of what would NOT be acceptable for both full costing and MC.

   Assume that the taxpayer used the product grouping illustrated above for all products except product Y. Taxpayer further grouped product Y with product N because it would benefit from such a grouping. This is not acceptable for two reasons:

   - First, the group would not be recognized industry trade or usage.
   - Second, the taxpayer would be using the same product in more than one group.

4. Some of the issues mentioned above were discussed in TAM 199948003.

3. Obtain the audit trail.

   Without a clear audit trail from the books of the R-S into the Schedule Ps, you will not be able to determine whether the taxpayer has used the same transaction more than once.

4. Do any of the groupings violate the regulations?

   Treas. Reg. § 1.994-1(d) prevents certain groupings, check to see if the grouping chosen violate any of the rules under this provision.

1. A sale transaction cannot be grouped with a lease transaction. See Treas. Reg. § 1.994-1(d)(1).

   So if product N was only leased, it could not be included in the medical waste product line grouping or the entity grouping.

2. Under the FSC tax regime military property sales was only allowed to be grouped with other military property sales. There is no similar rule under the DISC tax regime.

   Assume product X consisted solely of property described in IRC § 923(a)(5) and it was sold to the Government of Saudi Arabia. Product X could not be included in the nuclear fuel product line grouping nor the entity grouping.
3. Under FSC there was a special grouping rule for agricultural and horticultural products sold to a DISC by a qualified cooperative. There was no similar rule under the DISC regulations
4. QER from related and subsidiary services, which are booked in the same taxable year as the export property, can be grouped with the sale or lease to which they relate. See Treas. Reg. § 1.994-1(d)(3)(i)
5. QER from related and subsidiary services which are NOT booked in the same taxable year as the export property is subject to a different rule. These QERs can be grouped with the products or product lines to which the services are related, so long as the grouping of services chosen is consistent with the grouping of products or product lines for the taxable year the export property was sold. **See** Treas. Reg. § 1.994-1(d)(3)(ii).
6. QER from engineering or architectural services are treated on a transaction by transaction basis. See Treas. Reg. § 1.994-1(d)(3)(ii).
7. QER from a DISC rendering managerial services to an unrelated DISC is treated on a transaction-by-transaction basis. See Treas. Reg. § 1.994-1(d)(3)(ii).
8. The following groupings are not allowable groupings under IRC § 994:
   - Customer groupings,
   - Contract groupings,
   - Product or product line groupings within customer or contract groupings, and
   - Country-by-country (See Napp, discussed in section III. I.)

4. **DISC Claims**

   When the taxpayer files a claim, certain issues may arise including whether the claim was timely filed. The issues listed below were included in recent claims.

1. If the claim is for tax returns that were not audited, see IV above discussing how to start the audit. You will have to obtain the basic information: the audit trail, a description of the business and products exported, etc. You will need information for both the DISC and R-S.
2. If the claim is for tax returns that were audited, obtain the additional information described in the item 2 above regarding the claim. You will need information for both the DISC and R-S.
3. Does the claim include changes to the taxpayer’s groupings for administrative pricing? Read section V. C. above and obtain the audit trail from the taxpayer’s books and records into Schedule Ps.

1. If the taxpayer wants to change his groupings:

1. Obtain a definition of each new group and obtain the audit trail to the Schedule Ps.
2. Ask yourself the following:

1. Are the new groupings permissible?
2. Are the new groupings consistently applied?
3. Is the same transaction, product, or product line, used in more than one group?

3. If the taxpayer wants to "ungroup"?

1. Does the taxpayer have sufficient data to use the transaction by transaction method and is the computation of CTI correct?
2. Obtain a definition of the new transactions and/or groups.
3. Sometimes the taxpayer's definition of a transaction is really a combination of transactions. It may in fact be creating a group that is not permitted.

4. **Additional Sales** have been added to the DISC.

   Determine whether these sales qualify.

1. Follow the steps above in section V. A. regarding export property and QER.
2. Some of the reasons why sales should not be added include:
   - Property sold was not exported within one year of sale and
   - Sales were excluded from being QER under Treas. Reg. § 1.993-3(f). (This list is not all inclusive.)
3. Additional sales may impact some, or all, or the taxpayer's groupings.

5. No netting of interest an overlapping periods of tax overpayments and underpayments. IRC § 6621(d).

A change to the DISC commission income and the R-S's commission expense will generate both a refund and a deficiency. Since the DISC and the R-S are separate taxpayers, there is, for example, no netting of the interest income on the refund, with the interest expense on the DISC deficiency.

Footnotes:

[1] IRC § 6072(b).

[2] Prop. Reg. § 1.992-1(b)(3).

[3] See Treas. Reg. § 1.994-1(e)(1)(iii).

[4] Prop. Reg. § 1.991-1(b)(1) replaces the sentence in the old regulations that began with: "Thus, for example,…"

[5] See Prop. Reg. § 1.991-1(b)(3).

[6] A corporation created or organized in, or under the laws of, a possession of the Untied States can not qualify as a DISC. See Treas. Reg.§ 1.992-1(a).

[7] Treas. Reg. § 1.992-2(a)(1)(i).

[8] Treas. Reg. § 1.992-1(g)(3).

[9] Treas. Reg. § 1.992-2(b)(1)(i).

[10] See IRC § 992(b)(1)(B); Treas. Reg. § 1.992-2(d)(2).

[11] See Treas. Reg. § 1.992-2(b)(1)(iii).

[12] See Treas. Reg. § 1.992-2(e)(2) and (3).

[13] See Treas. Reg. § 1.992-3(a)(4).

[14] Treas. Reg. § 1.993-1(b).

[15] Treas. Reg. § 1.993-1(c).

[16] Treas. Reg. § 1.993-1(d).

[17] Treas. Reg. § 1.993-1(d)(4).

[18] Treas. Reg. § 1.993-1(e).

[19] Treas. Reg. § 1.993-1(f).

[20] Treas. Reg. § 1.993-1(g).

[21] Treas. Reg. § 1.993-1(h).

[22] Treas. Reg. § 1.993-1(i).

[23] See Treas. Reg. § 1.993-1(j).

[24] IRC § 993(a)(2)(flush) and Treas. Reg. § 1.993-1(i)(6).

[25] See Treas. Reg. § 1.993-1(k).

[26] Assets used primarily in the manufacture, production, growth, or extraction (within the meaning of Treas. Reg. § 1.993-3(c)) of property are not business assets.

[27] It is possible for the DISC to have QER when there is no export property. This can occur if the gross receipts are from certain management, engineering, or architectural services.

[28] IRC § 993(c)(1) and Treas. Reg. § 1.993-3(a).

[29] Although services are not export property, certain services can generate QER. This will be discussed in part III-C of this guide.

[30] Although the activity was held to be production, the property did not qualify as export property because the DISC produced and sold the veneer logs.

[31] Treas. Reg. § 1.993-3(a)(1) and (c)(1).

[32] Treas. Reg. § 1.993-3(c)(1).

[33] See IRC § 993(g) and Treas. Reg. § 1.993-7.

[34] Treas. Reg. § 1.993-3(c)(1).

[35] Treas. Reg. § 1.993-3(e)(4)(ii).

[36] Treas. Reg. § 1.993-3(e)(4)(i).

[37] The Commissioner acquiesced in result only in the General Electric decision. 2003-49 I.R.B. 1172 (2003).

[38] In Sim-Air, Tax Court upheld the validity of the one-year limitation contained in Treas. Reg. § 1.993-3(d)(2)(i)(b) before applying the regulation to the facts of the case.

[39] Related person is defined in Treas. Reg. § 1.993-1(a)(6).

[40] Treas. Reg. § 1.927(a)-1T(4)(iv). While not specifically written in the DISC regulations this was determined for FSC purposes after the enactment of FSC. It is expected that this same rule would similarly apply for DISCs as well.

[41] Temp. Treas. Reg. § 1.927(a)-1T(d)(1)(ii).

[42] Treas. Reg. § 1.993-3(d)(1)(ii).

[43] Treas. Reg. § 1.993-3(a)(4).

[44] Treas. Reg. § 1.993-3(f)(1)(i).

[45] Treas. Reg. § 1.993-3(f)(2).

[46] IRC § 993(c)(2)(B) and Treas. Reg. § 1.993-3(f)(3).

[47] Treas. Reg. § 1.993-3(g).

[48] Treas. Reg. § 1.993-3(h).

[49] Treas. Reg. § 1.993-3(i).

[50] IRC § 993(c)(2)(E).

[51] Treas. Reg. § 1.993-3(b).

[52] Treas. Reg. § 1.994-1(a)(2).

[53] Treas. Reg. § 1.994-1(a) (third sentence from the beginning).

[54] Treas. Reg. § 1.994-1(e)(1)(i).

[55] Treas. Reg. § 1.994-2(a).

[56] Treas. Reg. § 1.994-2(b)(1).

[57] See Treas. Reg. § 1.471-11(b)(2)(i) for a complete description of these costs.

[58] Treas. Reg. § 1.994-2(c)(1).

[59] Treas. Reg. § 1.994-2(b)(3).

[60] Treas. Reg. § 1.994-2(c)(2).

[61] Treas. Reg. § 1.994-2(d).

[62] Treas. Reg. § 1.994-1(c)(7).

[63] Treas. Reg. § 1.994-1(c)(7)(iii).

[64] Treas. Reg. § 1.995-1(a)(1).

[65] Treas. Reg. § 1.995-1(a)(2).

[66] Treas. Reg. § 1.995-1(a)(3).

[67] Treas. Reg. § 1.995-1(a)(4).

[68] Treas. Reg. § 1.995-6.

[69] Prop. Treas. Reg. § 1.995-2A(b).

[70] Calculation of limitation is as follows

$ 0 (DISC's accumulated DISC income / accumulated E&P at beginning of year is a ($10,000), but the amount

cannot be below $0)

+ 12,000 (DISC's current year earnings less any other deemed distributions, assumed no other deemed distributions)

$ 12,000

[71] Calculation of limitation is as follows

$10,000 (lesser of accumulated DISC income at beginning of year ($10,000) or accumulated E&P at beginning of

year ($13,000))

- 12,000 (deficit in DISC's E&P for the year)

(2,000)

[72] Treas. Reg. § 1.995-3(a) & (b).

[73] Treas. Reg. § 1.995-3(a).

[74] Treas. Reg. § 1.995-3(c).

[75] Id.

[76] Treas. Reg. § 1.995-3(d).

[77] Treas. Reg. § 1.995-3(e).

[78] Treas. Reg. § 1.995-4(a)(1).

[79] Treas. Reg. § 1.995-4(a)(2).

[80] Treas. Reg. § 1.995-4(d)(1).

[81] Prop. Treas. Reg. § 1.995-8(a).

[82] Controlled group is defined in IRC § 993(a)(3) with reference back to IRC § 1563(a) but substituting 50% instead of 80%.

[83] Treas. Reg. § 1.995-8(a) and (f)(3).

[84] Treas. Reg. § 1.995-8(b)(1).

[85] Treas. Reg. §1.995-8(b)(2).

[86] Treas. Reg. § 1.995-8(b)(3).

[87] Treas. Reg. § 1.995-8(c).

[88] Prop. Treas. Reg. § 1.995(f)-1(a)(1).

[89] Prop. Treas. Reg. § 1.995(f)-1(a)(2).

[90] Base T-bill rate is defined in Prop. Treas. Reg. § 1.995(f)-1(b)(2).

[91] Prop. Treas. Reg. § 1.995(f)-1(b)(1).

[92] Prop. Treas. Reg. § 1.995(f)-1(d).

[93] Prop. Treas. Reg. § 1.995(f)-1(f).

[94] Prop. Treas. Reg. § 1.995(f)-1(d)(2)(ii).

[95] Prop. Treas. Reg. § 1.995(f)-1(d)(2)(iii).

[96] Prop. Treas. Reg. § 1.995(f)-1(d)(2)(iv).

[97] Prop. Treas. Reg. § 1.995(f)-1(d)(7).

[98] Treas. Reg. § 1.996-1(a).

[99] Treas. Reg. § 1.996-1(b)(1).

[100] Prop. Treas. Reg. § 1.996-1(b)(2)(ii).

[101] Treas. Reg. § 1.996-1(d).

[102] R&D is also known as research and experimental ("R&E") and is referred to as such in Treas. Reg. § 1.861-17.

[103] The old regulations referred to a 2-digit SIC code. Treas. Reg. § 1.861-17 (effective January 1, 1996) allows for the "allocation of research and experimental expenditures to three-digit SIC code product categories of gross income." See T.D. 8646.

[104] In St. Jude, the taxpayer designed and manufactured three products: insulin pumps, pacemakers, and artificial hearts. St. Jude allocated neither its insulin pump nor its pacemaker R&D expenditures against its artificial heart valve export receipts in its CTI computations. However, Treas. Reg. § 1.861-8(e)(3) required the allocation of R&D expenditures against broad Standard Industrial Classifications ("SIC") categories. The insulin pump, pacemaker, and artificial heart valves fell within the same two digit SIC category. The court sided with the taxpayer and viewed Treas. Reg. § 1.994-1(c)(6) in conflict with the Treas. Reg. § 1.861-8(e)(3). Treas. Reg. § 1.994-1(c)(6) allowed the taxpayer a choice in grouping its transactions rather than a mandate as in Treas. Reg. § 1.861-8(e)(3). Thus, the court held that the taxpayer was not required to allocate its insulin pump or pacemaker R&D expenditures for purposes of calculating CTI.

The IRS nonacquiesced to the opinion. See AOD-1999-05.

[105] Treas. Reg. § 1.861-8(e)(2), the predecessor of Treas. Reg. § 1.861-17, used a 2 digit SIC code.

[106] This example is not based upon any known case or taxpayer. Any similarity to an actual business or taxpayer, or actual SIC codes, is the result of coincidence, not design.

[107] The OPPL is computed by multiplying the QER by the OPP. The OPP is determined under Treas. Reg. § 1.994-2(c)(2) as follows:

$$\frac{\text{Full Costing CTI for DISC and R-S of BOTH domestic and export of a product or product line}}{\text{Domestic and Export Sales of the product or product line}}$$