Advance International, Inc. v. Commissioner, 91 T.C. 445 (1988)

Amounts transferred from a Domestic International Sales Corporation (DISC) to its parent company, recorded as a debit balance in an intercompany clearing account and not directly tied to specific export inventory purchases, do not qualify as 'qualified export assets' for purposes of meeting the DISC qualification requirements and are treated as actual distributions.

Summary

Advance International, Inc. (International), a DISC subsidiary of Advance Machine Co. (Machine), sought to qualify as a DISC for tax purposes. A key requirement for DISC qualification is that at least 95% of a DISC's assets must be 'qualified export assets.' International routinely transferred funds to Machine, its parent, for anticipated export production, recording these transfers as debits in an intercompany clearing account. International argued this debit balance, representing funds advanced to Machine, should be considered a qualified export asset. The Tax Court disagreed, holding that because these transfers were not directly linked to specific export inventory or orders and were unrestricted in use by Machine, the debit balance did not constitute a qualified export asset. Consequently, International failed the 95% assets test for DISC qualification, and the transfers were deemed actual distributions to the parent company.

Facts

Advance Machine Co. (Machine) manufactured floor cleaning equipment and related products, selling both domestically and internationally.

Advance International, Inc. (International) was Machine's wholly-owned subsidiary, formed to operate as a Domestic International Sales Corporation (DISC) to handle export sales.

International operated as a buy-sell DISC, purchasing export products from Machine and reselling them abroad.

International maintained an intercompany clearing account to record cash transfers to Machine and charges for the cost of goods sold.

International periodically transferred cash to Machine for anticipated export production, but these transfers were not tied to specific orders or inventory and were deposited into Machine's general bank accounts without restrictions on use.

The debit balance in the intercompany clearing account at the end of fiscal years 1980 and 1981 was listed by International as a qualified export asset.

The IRS determined that International did not qualify as a DISC because this debit balance was not a qualified export asset, causing International to fail the 95%

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qualified export assets test.

Procedural History

The Commissioner of Internal Revenue issued statutory notices of deficiency to Advance Machine Co. and Advance International, Inc. challenging International's DISC qualification for fiscal years 1980, 1981, and 1982.

The cases were consolidated in the United States Tax Court.

The parties stipulated that International qualified as a DISC for fiscal year 1982.

The remaining issue for fiscal years 1980 and 1981 was whether the adjusted basis of International's qualified export assets equaled or exceeded 95 percent of its total assets, specifically concerning the debit balance in the intercompany clearing account.

Issue(s)

Whether, for fiscal years 1980 and 1981, the debit balance in International's intercompany clearing account with Machine constituted a 'qualified export asset' within the meaning of section 992(a)(1)(B) of the Internal Revenue Code, such that International met the 95% qualified export assets test for DISC qualification.

Holding

No, because the debit balance in International's intercompany clearing account did not represent a qualified export asset as defined in section 993(b) of the Internal Revenue Code. Therefore, International did not meet the 95% qualified export assets test for DISC qualification for fiscal years 1980 and 1981.

Court's Reasoning

The court reasoned that to qualify as a DISC, a corporation must meet several conditions, including the 95% qualified export assets test under section 992(a)(1)(B).

Qualified export assets are specifically defined in section 993(b), and the intercompany account debit balance did not fall into any of the enumerated categories, particularly not as 'export property' under section 993(b)(1) and (c) or as 'temporary investments' under section 993(b)(4).

The court distinguished this case from situations where advance payments might be considered qualified export assets if they are directly tied to the acquisition of export inventory. Here, the cash transfers were general, unrestricted, and not specifically designated for or traced to export inventory purchases.

The court emphasized that "We cannot overlook the fact that the payments to

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Machine were made independently of orders for export product and there were no restrictions on Machine's use of the funds once they were received. Furthermore, no efforts were ever made to correlate the payments with orders for inventory or to designate the transfers as payments for inventory."

The court cited legislative history indicating Congress intended to limit the use of DISC untaxed earnings to export-related activities or specific types of producer's loans, neither of which applied to the unrestricted intercompany transfers in this case.

Because the transfers were not qualified export assets and were not intended as loans, the court concluded they were actual distributions from International to Machine. "On these facts we can conclude only that the amounts transferred by International to Machine during each year in issue in excess of cost of goods sold and adjustments to transfer price were actual (not constructive) distributions of International's earnings."

Practical Implications

This case clarifies that for a DISC to treat intercompany advances to a parent company as qualified export assets, those advances must be demonstrably and directly linked to the purchase of specific export inventory.

General, unrestricted cash transfers to a parent company, even if intended for export production, will not qualify as export assets if they are not tied to specific inventory or orders.

This ruling underscores the importance of proper documentation and accounting practices for DISCs to maintain qualification, particularly in intercompany transactions.

The case highlights the strict interpretation of the 'qualified export assets' test and the necessity for DISCs to adhere to the specific categories defined in section 993(b) to maintain their tax-advantaged status.

Practitioners advising DISCs should ensure that intercompany fund transfers are structured and documented as either qualified producer's loans or direct payments for specifically identifiable export property to avoid treatment as non-qualified assets or distributions.

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