Garnac Grain Co. v. Commissioner, 95 T. C. 7 (1990)

The term ‘production’ for DISC qualification must be generally considered as such within the industry, not merely based on substantial activities.

Summary

Garnac Grain Co. , a grain merchant, sought to qualify its subsidiary, Garnac Grain Export Corp. , as a Domestic International Sales Corporation (DISC) to receive tax benefits. The central issue was whether Garnac’s grain handling activities constituted ‘production’ under IRS regulations, which would allow loans from the DISC to qualify as ‘producer’s loans. ’ The Tax Court held that Garnac’s operations, although substantial, were not generally considered production in the grain industry. Additionally, the court ruled that market adjustments on open trades did not count as export-related assets for DISC qualification, denying the loans’ status as producer’s loans.

Facts

Garnac Grain Co. operated as a worldwide grain merchant, primarily purchasing, storing, cleaning, drying, aerating, fumigating, and blending grain for export. Garnac owned all shares of Garnac Grain Export Corp. , a DISC that made loans to Garnac totaling $5. 4 million in March 1974. These loans were designated as ‘producer’s loans’ to qualify as tax-exempt under the DISC rules. Garnac’s operations involved sophisticated equipment and skilled personnel to meet export specifications, but the grain was not transformed into a different product. Garnac’s balance sheets included ‘Market adjustments on open trades,’ representing the yearend value of future grain purchase and sales contracts.

Procedural History

The Commissioner determined deficiencies in Garnac’s federal income taxes for the years 1974 through 1981, challenging the DISC status of Garnac Grain Export Corp. and the tax treatment of the loans as producer’s loans. Garnac petitioned the Tax Court for redetermination. After concessions, the remaining issues were whether Garnac was engaged in the production of export property and whether market adjustments on open trades counted as export-related assets.

Issue(s)

1. Whether Garnac Grain Co. was engaged in the ‘manufacturing, production, growing, or extraction of export property’ within the meaning of section 993(d)(1)(C) during the years in issue.
2. Whether Garnac’s balance sheet item entitled ‘Market adjustments on open trades’ is ‘property held for sale to customers’ for the purposes of computing increased investment in export-related assets under section 993(d)(3).

Holding

1. No, because Garnac's activities, while substantial, were not generally considered in the industry to constitute production.
2. No, because market adjustments on open trades do not represent property held for sale to customers and therefore cannot be included in the calculation of export-related assets.

Court's Reasoning

The court analyzed whether Garnac's operations qualified as production under section 993(d)(1)(C). It found that while Garnac's operations were substantial, involving complex processes and skilled personnel, they were not generally considered production in the grain industry. The court relied on expert testimony and industry perception, noting that the grain industry typically viewed such operations as assembly and packaging rather than production. The court distinguished this case from prior cases involving the investment tax credit, where a broader definition of production was applied. Additionally, the court ruled that market adjustments on open trades did not qualify as property held for sale to customers, as required under section 993(d)(3), because they did not represent actual inventory. The court emphasized the need for the DISC to demonstrate an increased investment in export-related assets, which Garnac could not do with market adjustments.

Practical Implications

This decision clarifies that for DISC qualification, the term 'production' requires more than substantial activities; it must be generally recognized as production within the industry. Legal professionals must consider industry norms when advising clients on DISC eligibility. The ruling also affects how companies value inventory for tax purposes, particularly in industries using mark-to-market accounting. Businesses in similar sectors must carefully evaluate whether their operations meet the IRS's production criteria to qualify for DISC benefits. The decision underscores the importance of aligning tax strategies with specific statutory definitions and industry practices, potentially impacting business planning and tax structuring in export-related operations.

