Computervision Corp. v. Commissioner, 96 T. C. 652 (1991)

The full amount of discount on transferred export accounts receivable must be deducted from combined taxable income (CTI) under full cost accounting, and export promotion expenses must be incurred by the DISC to be included in its commission calculation.

Summary

Computervision Corp. used a domestic international sales corporation (DISC) as a commission agent for its export sales. The key issue was the proper allocation of a discount on transferred accounts receivable and the inclusion of export promotion expenses in the DISC's commission calculation. The Tax Court held that under full cost accounting, the entire discount must be deducted from the combined taxable income (CTI) of the DISC and its related supplier, following the precedent set in Dresser Industries v. Commissioner. Additionally, the court ruled that export promotion expenses could not be included in the commission calculation because the DISC did not perform substantial economic functions as required by the regulations. This decision impacts how companies structure their DISC arrangements and account for expenses related to export sales.

Facts

Computervision Corp. (Petitioner) used Computervision International Corp. (International), its wholly-owned subsidiary, as a DISC to facilitate export sales. In 1981, Petitioner transferred accounts receivable to International at a discount, totaling $4,661,026. Petitioner and International had agreements in place to designate certain departments as Foreign Marketing Departments, and Petitioner treated various expenses as export promotion expenses incurred by International. Petitioner calculated International's commission using the intercompany pricing method under section 994(a)(2), grouping sales by product lines and computing CTI under both full and marginal cost accounting methods.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Petitioner's 1981 federal income tax. Petitioner filed a petition with the U. S. Tax Court, challenging the Commissioner's adjustments related to the allocation of discounts and the inclusion of export promotion expenses in the DISC's commission calculation. The Tax Court issued its opinion on April 16, 1991, affirming the Commissioner's position on the discount allocation and export promotion expenses.

Issue(s)

1. Whether the full amount of the discount incurred on the transfer of export accounts receivable from Petitioner to International must be deducted from their combined taxable income (CTI) computed under full cost accounting.

2. Whether the discount is properly incorporated into the computation of CTI under marginal cost accounting as limited by the overall profit percentage limitation (OPPL).
3. Whether export promotion expenses incurred by Petitioner pursuant to a written agreement with International may be included in the commission payable to International.

Holding

1. Yes, because the regulation requires that the full amount of the discount be deducted from CTI under full cost accounting to prevent double-counting of income.
2. Yes, because the discount is incorporated into the computation of the OPPL by reducing full costing CTI in the numerator of the overall profit percentage (OPP).
3. No, because the expenses were not incurred by International as required by the regulations, and the designation agreement did not establish that International performed substantial economic functions.

Court's Reasoning

The court applied the regulation requiring full deduction of the discount from CTI under full cost accounting, citing Dresser Industries v. Commissioner as precedent. This approach prevents the discount from being counted twice in determining DISC taxable income. For marginal cost accounting, the court interpreted the regulations to mean that the discount reduces full costing CTI in the numerator of the OPP, thereby affecting the OPPL calculation. Regarding export promotion expenses, the court emphasized that these must be incurred by the DISC itself, as per the regulations. The court found that the designation agreement did not establish that International incurred these expenses, as International was essentially a shell corporation without employees performing business functions. The court quoted the regulations to support its interpretation and emphasized the need for the DISC to perform substantial economic functions to include such expenses in its commission calculation.

Practical Implications

This decision clarifies that discounts on transferred accounts receivable must be fully deducted from CTI under full cost accounting, impacting how companies calculate their taxable income in DISC arrangements. It also sets a precedent for the treatment of discounts in marginal cost accounting, requiring careful calculation of the OPPL. Additionally, the ruling underscores the importance of the DISC performing substantial economic functions to include export promotion expenses in its commission calculation, affecting how companies structure their DISC operations. Practically, this decision may lead companies to reassess their DISC arrangements to ensure compliance with the regulations and to avoid disallowance of export promotion expenses. Later cases, such as Dresser Industries, have followed this ruling, reinforcing its impact on tax practice in this area.

