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IC-DISC: Mastering Intricacies of the Federal Tax Incentive for Exporters

Overcoming Compliance Challenges to Maximize Tax Benefits

WEDNESDAY, DECEMBER 7, 2011

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Neal Block, Senior Counsel, Baker & McKenzie, Chicago

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IC-DISC: Mastering Intricacies of the Federal Tax Incentive for Exporters Seminar

Dec. 7, 2011

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Today's Program

Fundamental Concepts Of IC-DISCs
[Tom Miller]

Slide 7 - Slide 24

Implementing Various Ownership Structures For IC-DISCs
[Neal Block]

Slide 25 - Slide 39

Compliance And Reporting By IC-DISCs
[Jerry Ogle]

Slide 40 - Slide 49

Tom Miller, BKD

FUNDAMENTAL CONCEPTS OF IC-DISCs



Domestic International Sales Corporations (DISCs)

- Background and tax benefits of DISCs
 - General review of tax benefits of DISCs
 - How the DISC came to be
- Requirements of a DISC
 - Initial requirements
 - Annual requirements
- Export property
- Other considerations



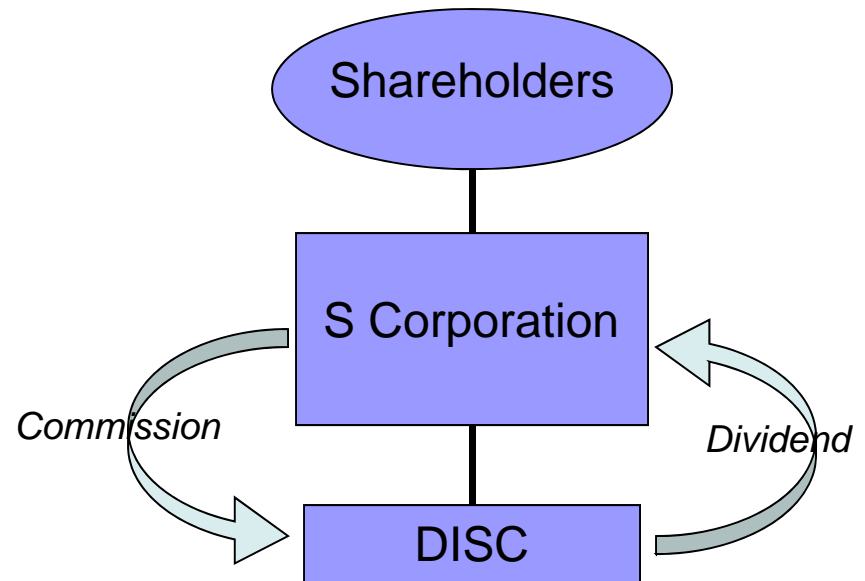
Domestic International Sales Corporations (DISCs), Cont.

DISC benefit arises as follows:

- Commissions paid to a DISC reduce taxable profit of related supplier corporation.
- DISC is tax-exempt entity – Sect. 991
- DISC dividends received by individual shareholder are taxed at capital gains rate.
 - Currently 15%

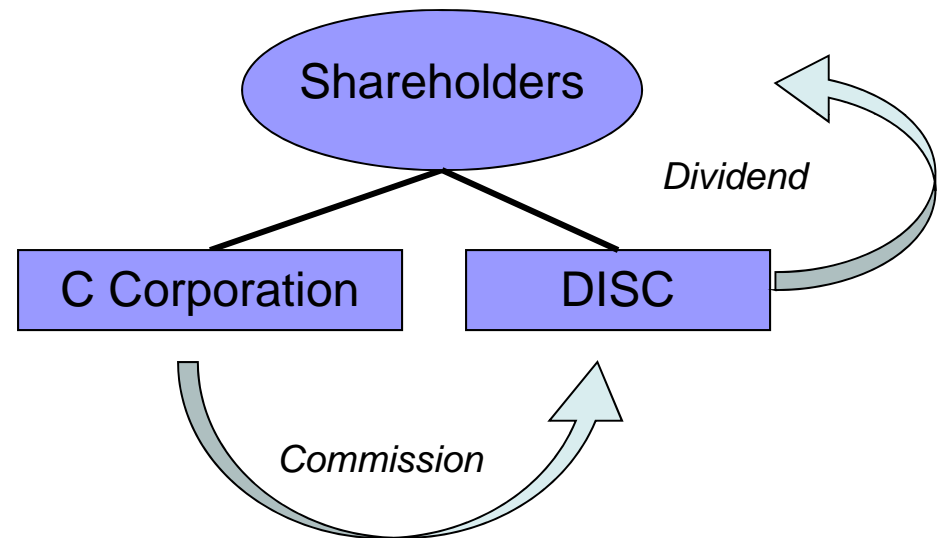
General Review Of DISCs: Pass-Through Structure

- Commission reduces taxable profit passed through to S corporation shareholder (35% tax savings).
- DISC is not subject to tax.
- S corporation shareholders pay 15% tax on DISC dividends.
- Shareholders are subject to an interest charge for the tax deferral on DISC earnings not distributed or deemed distributed.



General Review Of DISCs: C Corporation Structure

- Commission reduces taxable profit of C corporation (34-35% tax savings).
- DISC is not subject to tax.
- C corporation shareholders pay tax at 15% on DISC dividend.
- Shareholders are subject to an interest charge for the tax deferral on DISC earnings not distributed or deemed distributed.





How DISCs Came To Be

- 1971: Congress enacted DISC provisions
 - U.S. tax on DISC income was deferred until it was repatriated.
- 1970s – 1980s: European Union (EU) challenged DISCs as allegedly violating General Agreement on Tariffs and Trade (GATT).
- 1984: Congress enacted foreign sales corporation (FSC) provisions.
 - FSC provided U.S. exporters with a partial U.S. tax exemption on export income.
 - DISC was modified to allow deferral of DISC income from annual maximum of \$10 million of export receipts but interest charges on deferral.



How DISCs Came To Be (Cont.)

- Late 1990s: European Union (EU) members complain to World Trade Organization (WTO) that FSC represents an illegal export subsidy, but DISC was not challenged.
- 2000: Congress repeals FSC tax scheme and enacts extraterritorial income exclusion (ETI or EIE); EU immediately lodged complaints.
- 2003: Congress enacts favorable dividend tax rates for individuals.
 - Tax rate drops from 35% to 15%, creating an opportunity for permanent savings.



How DISCs Came To Be (Cont.)

- 2004: Congress repealed ETI
- 2006: IRS becomes aware of DISC planning. Congress proposes legislation to repeal benefit. Legislation is not passed.
- 2007: Repeal of capital gain rate for DISC dividends is included with Rangel bill. Again, legislation is not enacted. Proposal has not been raised again.
- Dec. 31, 2012: Favorable dividend tax rates are set to expire!



DISC Initial Set-Up

- Commission DISC vs. buy/sell DISC
- Domestic corporation (C corporation)
 - Must be a domestic corporation incorporated under the laws of any state or the District of Columbia
 - Determine state tax implications
- Single class of stock
- \$2,500 capital
 - Required by last day to elect IC-DISC status



DISC Initial Set-Up (Cont.)

- Form 4876-A election
 - File within 90 days from the beginning of tax year or inception of entity
- Establish books and records by the end of first year of operation



DISC Annual Maintenance

- 95% qualified gross receipts test
- 95% qualified export assets test
- \$2,500 capital on each day of tax year
- Timely payment of commission to IC-DISC
- File IC-DISC income tax return
- Maintain IC-DISC books
- International boycott reporting



DISC Annual Maintenance (Cont.)

95% qualified gross receipts test

- Qualified gross receipts are at least 95% of IC-DISC gross receipts for the year.
- Qualified gross receipts:
 - Sale, exchange or other disposition of export property
 - Lease or rental of export property used outside of U.S.
 - Related and subsidiary services
 - Dividends from related foreign export corporation
 - Interest on obligations that are qualified export assets
 - E.g., producer's loans
 - Engineering and architectural services



DISC Annual Maintenance (Cont.)

95% qualified gross receipts test (Cont.)

- Other receipts to consider
 - Sales made to U.S. distributors
 - Sales made to foreign disregarded entities
- Excluded receipts
 - Export property is for ultimate use in the U.S.
 - The sale, lease, etc. is accomplished by a subsidiary of the U.S. government.
 - The export property is for the use by the US government, where the use is required by law or regulation.



DISC Annual Maintenance (Cont.)

95% qualified export asset test

- At least 95% qualified export assets at year-end are qualified.
- Categories of export assets
 - Export property
 - Working capital
 - Only amount necessary for required working capital
 - Commission receivable
 - Stock or securities of related foreign export corporation
 - Producer's loans



DISC Annual Maintenance (Cont.)

- Commission payment
 - Payment of initial commission estimate within 60 days of DISC's year-end (March 2, calendar year).
- Any unpaid commission must be paid within 90 days of finalization.
 - Unpaid amount cannot be more than original estimate – i.e., estimate must be at least 50% of final.
- File IC-DISC return (Form 1120-IC-DISC)
 - Due within 8 ½ months of year-end
- Maintain IC-DISC books and records



Export Property For DISC (1.993-3)

- Manufactured, produced, grown or extracted in the U.S. by a person other than a DISC
- Held primarily for sale, lease or rental for direct use, consumption or disposition outside the U.S.
- Not more than 50% of fair market value of the export property can be attributable to foreign content.
- Consider qualified export property sold to U.S. distributors



Other Considerations

- DISC commission reduces QPAI deduction.
 - Relates to the deduction for domestic production activities
- DISC commission reduces profit on foreign title transfer sales. [Sect. 863(b)]
 - May reduce foreign tax credit limitation
- Provide for deferred tax on accumulated DISC income (FAS 109/APB 23)
- State income tax considerations



Problems?

- Failure to file Form 4876-A timely
 - 9100 relief
- Distribution needed to meet qualification requirements
 - Deficiency distribution
 - Failure to meet 95% qualified export asset test and 95% qualified gross receipts test, as well as timely paying commission
 - Equal to amount of taxable income attributed to the non-qualified portion
 - Deemed reasonable cause if paid on or before 15th day of ninth month after year
 - If paid after, interest in the amount equal to 4.5% of distribution [§992(c)(2)(b)]

Neal Block, Baker & McKenzie

IMPLEMENTING VARIOUS OWNERSHIP STRUCTURES FOR IC-DISCs



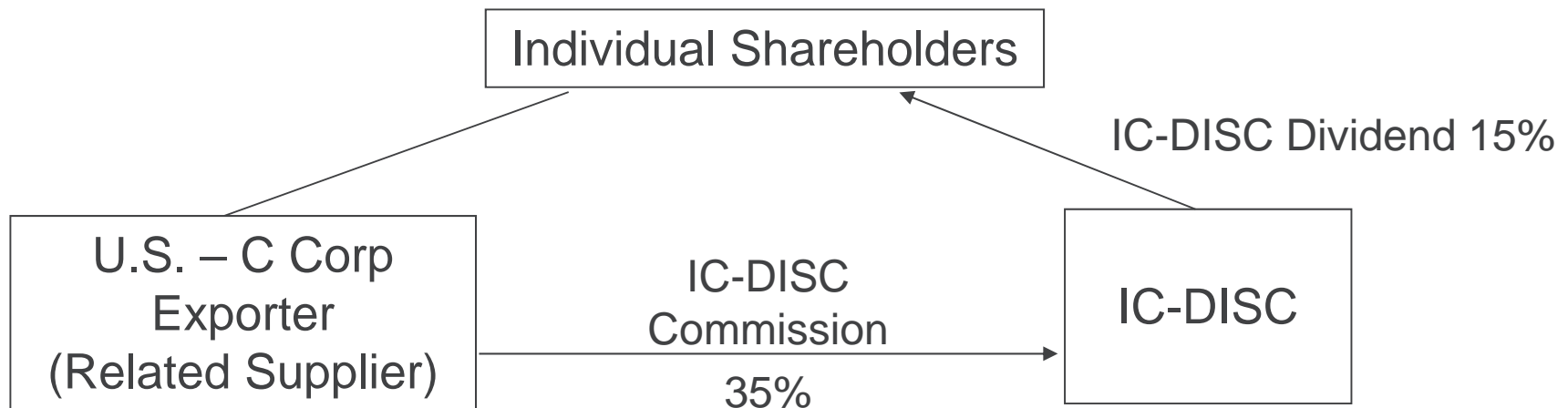
Overview Of This Section

- Privately held company: C corporation, S corporation, partnership, LLC taxed as a partnership
- Publicly traded C corporation
- Individual Retirement Account (IRA) and Roth IRA
- Treaty benefits

Privately Held Company

C Corporation

- Dividends to C corporation shareholders subject to corporate tax at approximately 35%
- Recommended that IC-DISC be owned directly by the individual shareholders of the C corporation so they can avoid double taxation and receive dividends at 15% capital gains rate

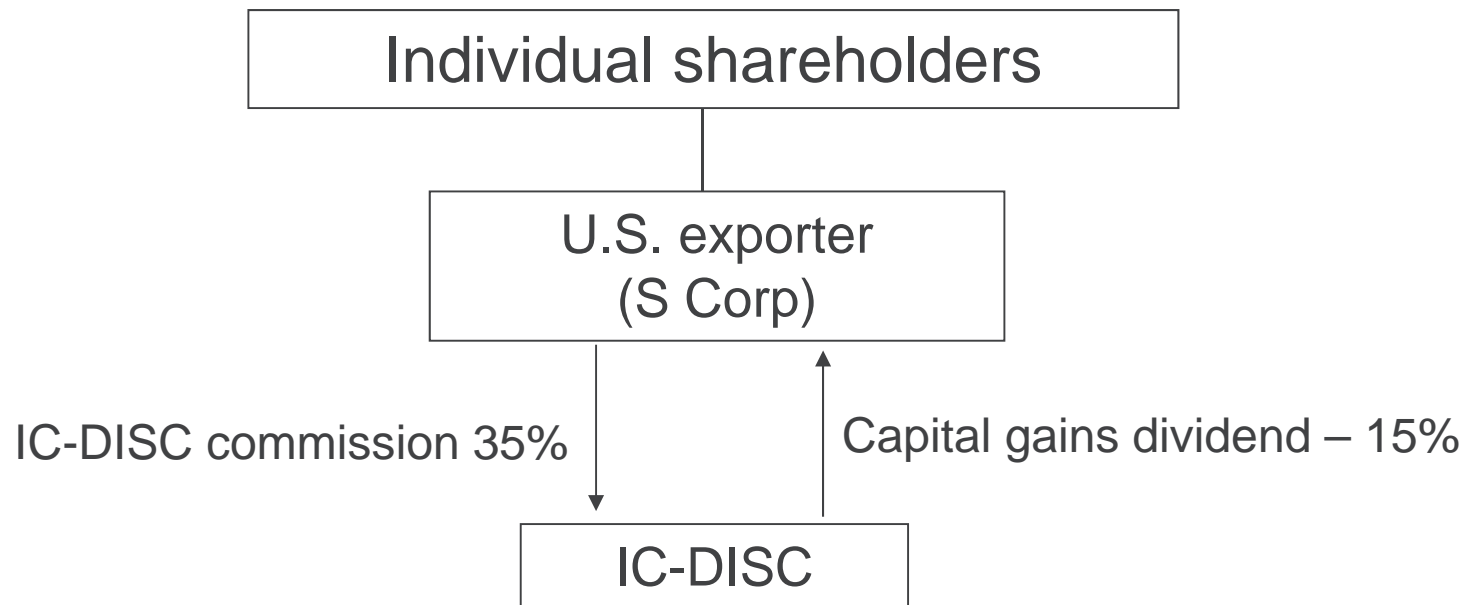


Where exporter shareholder include C corporations or tax exempt entities, alternative structures may be used for their ownership.

Privately Held Company (Cont.)

S corporation and LLC

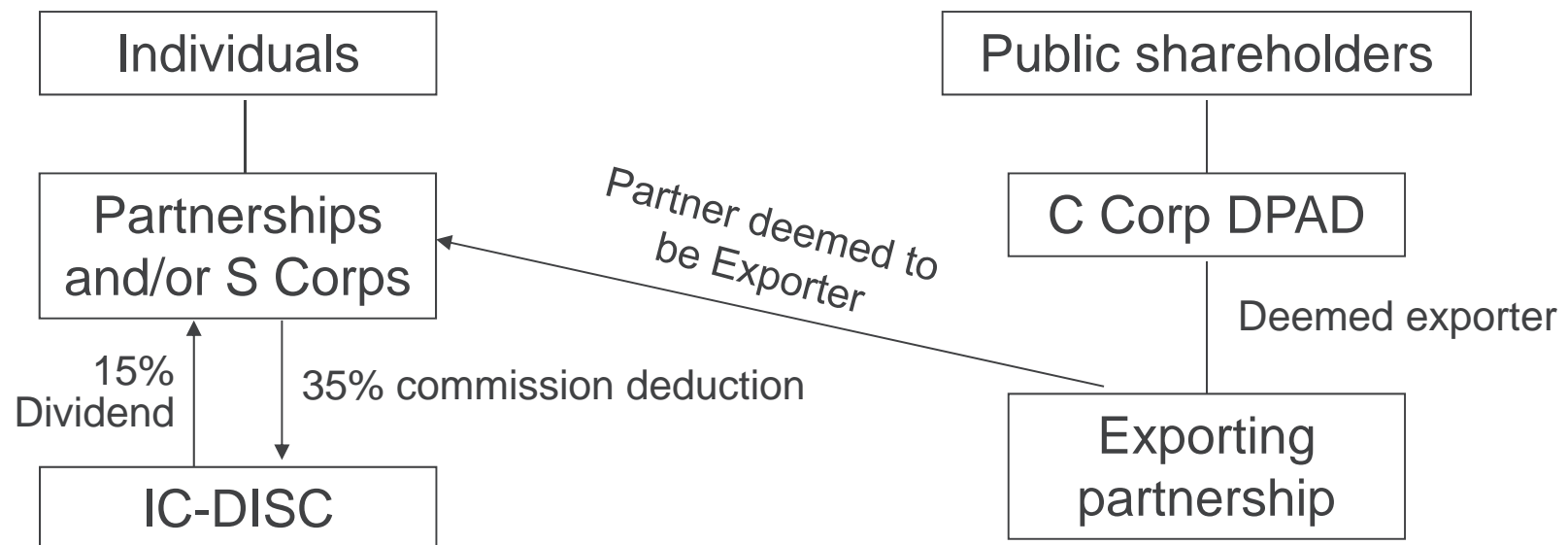
- Dividends pass through the corporation to the shareholders, are deferred from taxes, and receive dividends taxed at the 15% capital gains rate.



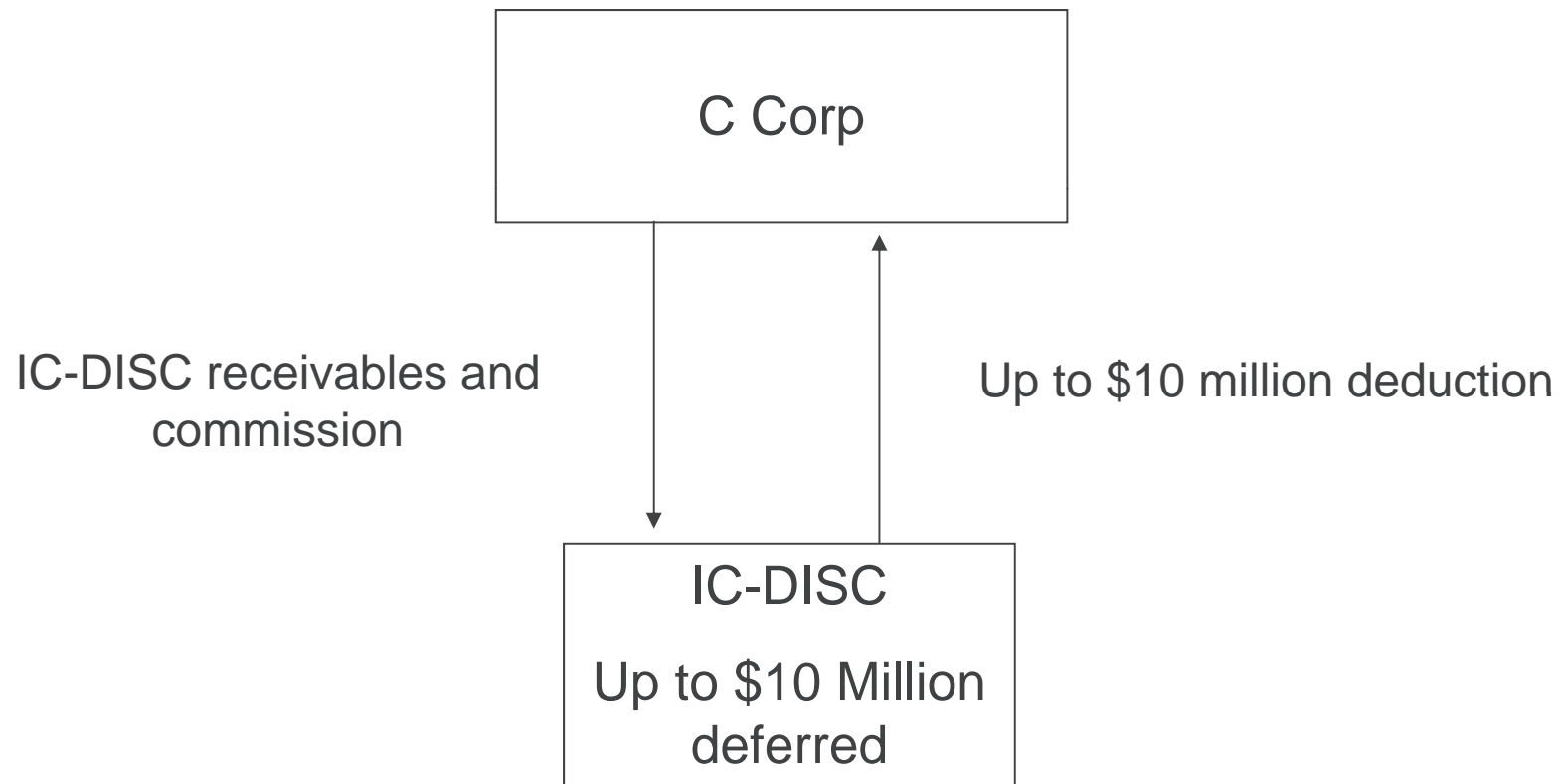
Privately Held Company (Cont.)

Partnership Owned by S Corporation

- Dividends pass through the partnership to the partners and shareholders of the S corporations and taxed at the 15% capital gains rate



Publicly Traded Corporation - Deferral





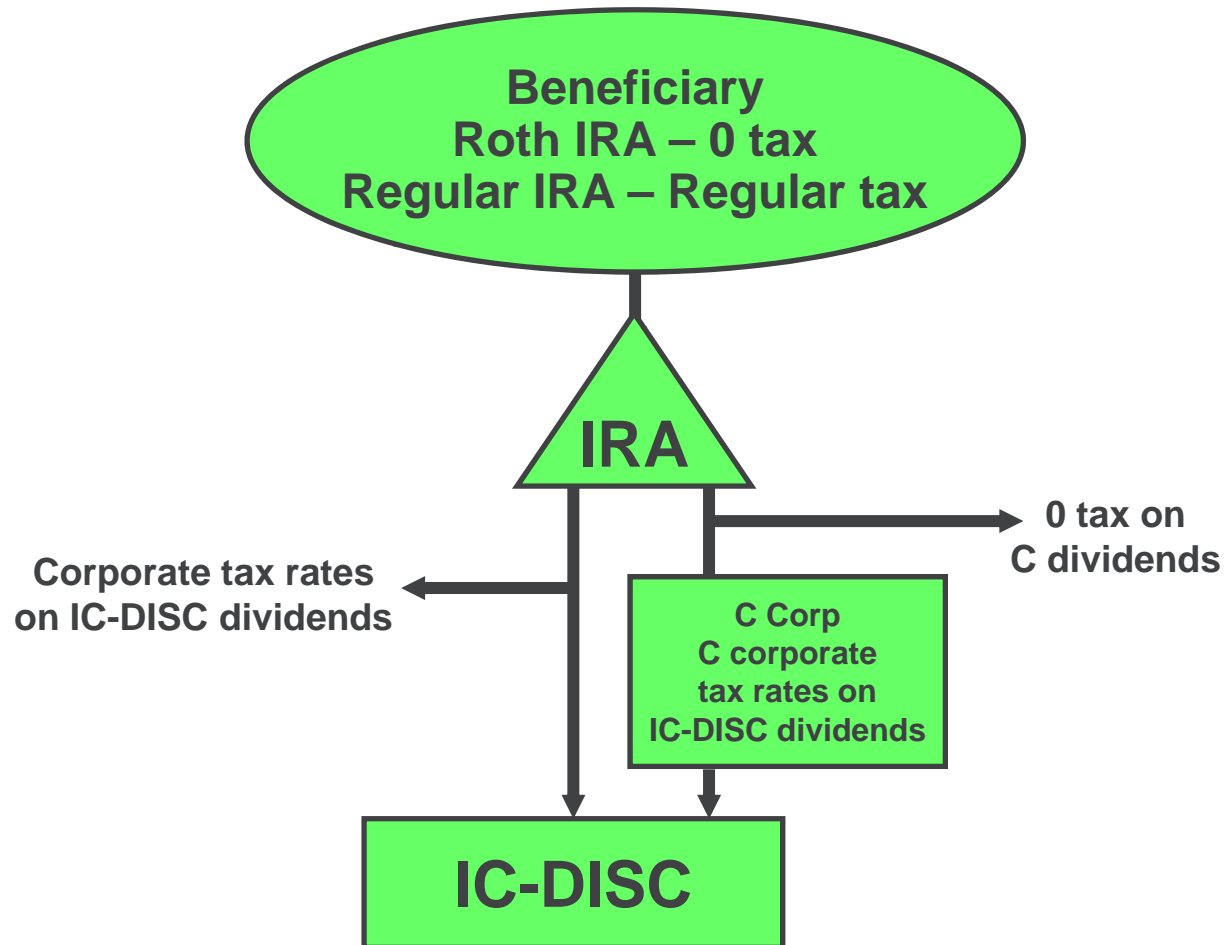
Publicly Traded Corporation

- IC-DISC may defer from taxation 16/17 of best \$10 million of gross receipts. The balance is deemed distributed to its shareholders.
- Large exporters that generate substantial export receivables can sell the receivables to the IC-DISC at a discount. The discount income qualifies as qualified export receipts.

Publicly Traded Corporation (Cont.)

- Deferred income becomes a low-cost, pre-tax source of funds for export working capital and financing international sales.
- As much as \$10 million may be generated from discount income and 16/17 deferred from tax (i.e., \$1 of discount income = \$1 of gross receipts).
- Additional deferral is available by use of non-qualified assets, up to 5% of total IC-DISC assets.

Individual Retirement Account





IRA IC-DISC Benefits: Use Of C Corp To Own IC-DISC Stock

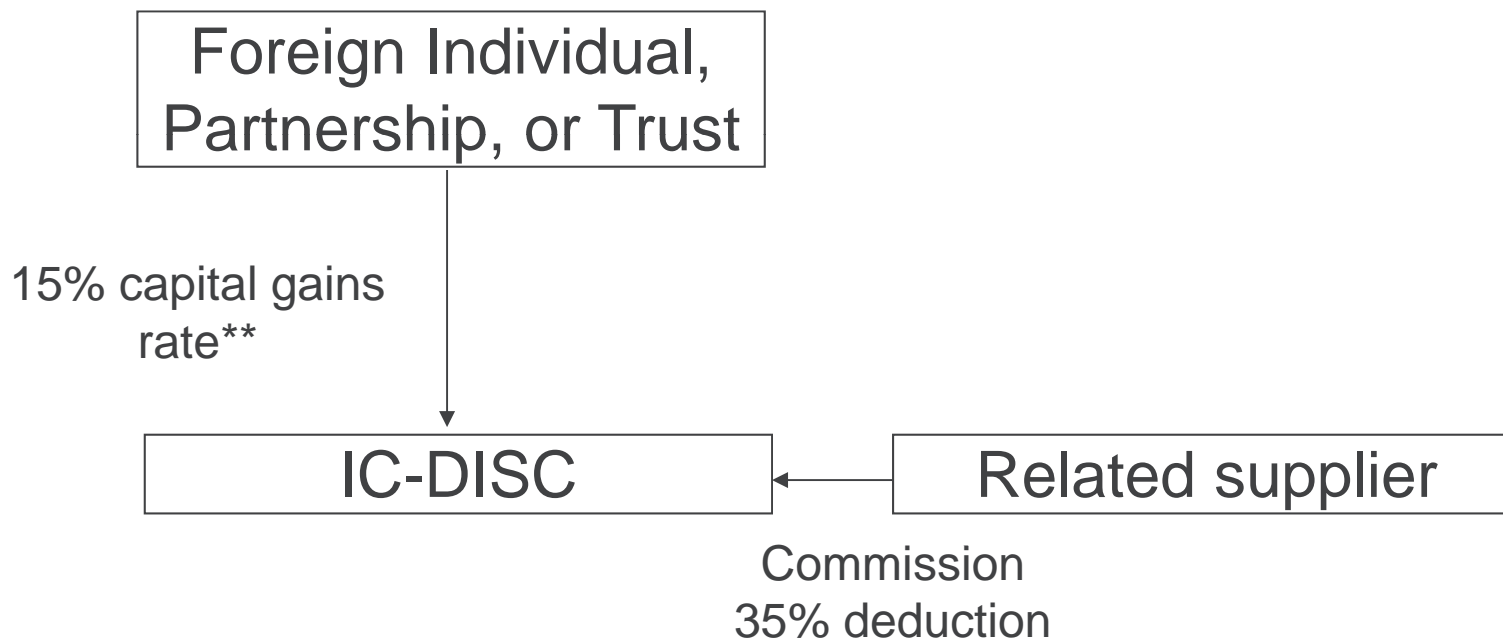
- Allows dividends from IC-DISC to be taxed to C corporation at corporate rates of 15% - 35%
- Dividends from C corporation to IRA tax-free
- Assets invested by IRA tax-free
- Distributions taxed when distributed by regular IRA distributions, tax-free when distributed by Roth IRA
- May be combined with IRS direct ownership of IC-DISC stock



IRA IC-DISC Benefits: IRA Ownership Of IC-DISC

- Accumulated IC-DISC income taxed at corporate rates 15-35% when distributed
- Assets in IRA invested tax-free
- Multiple IRA structures could reduce total tax on IC-DISC dividends
- Use of LLC owned by IRA to avoid custodian involvement
- Roth IRA distributions not taxed to beneficiaries
- Tax Court has now ruled that no excise tax, and probably no gift tax, is applicable to ROTH IRA/DISC structure. See *Hellweg v. Commissioner*, Tax Court Memorandum 2011-98

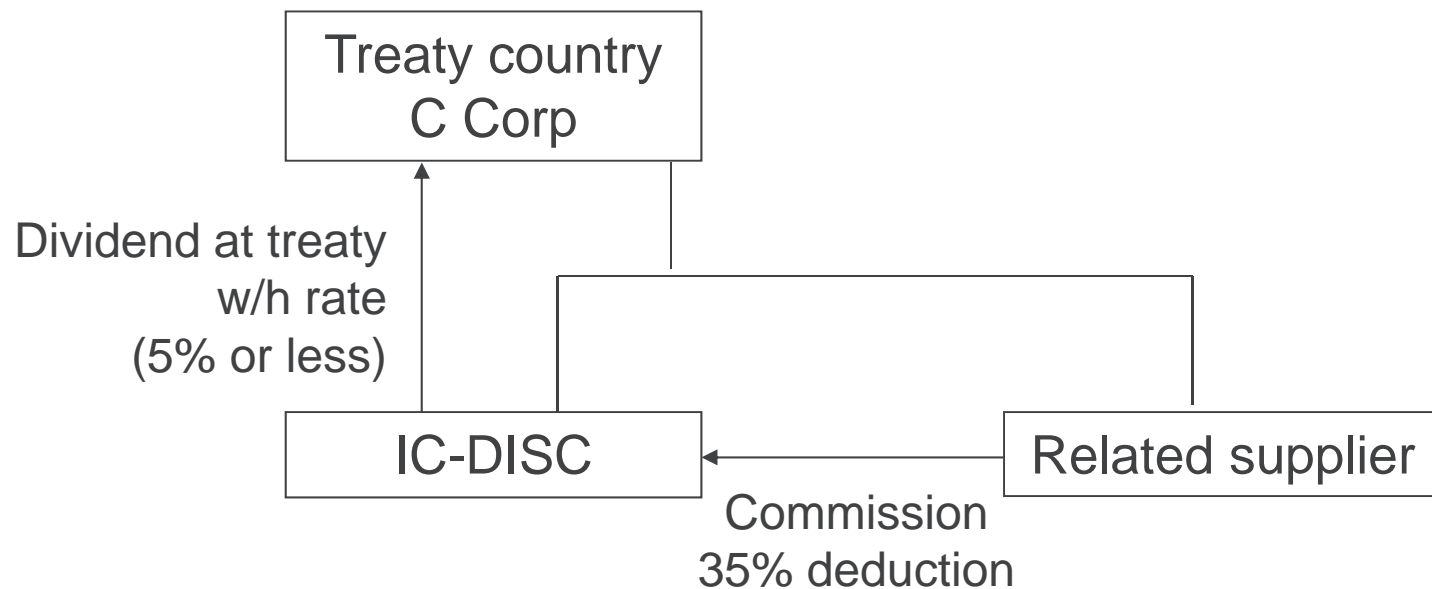
Foreign Individual, Partnership Or Trust* Structure



* Trust not taxed as a corporation.

** Possible treaty rate same as following treaty country corporation structure

Treaty Country Corporation Structure





Treaty Benefits: Ownership Of IC-DISC By Treaty Country Corporation

- Sect. 996(g) classifies IC-DISC dividends as effectively connected with the conduct of a trade or business in the U.S. through a permanent establishment. This would likely result in foreign corporation shareholder of an IC-DISC being subject to tax on IC-DISC dividends at up to 35%.
- Sect. 996(g) is in conflict with most treaties, which prevent taxation of a treaty country corporation in the absence of an actual permanent establishment (i.e., the mere existence of a U.S. subsidiary is not sufficient for U.S. taxation of dividends to parent as effectively connected income through a permanent establishment).



Treaty Benefits: Ownership Of IC- DISC By Treaty Country Corporation (Cont.)

- Under the later-in-time theory, treaties executed after June 1984, therefore, may prevent 996(g) from applying.
- IC-DISC dividends may thus be subject to zero tax or taxed at the treaty rate on dividends.
- If a foreign owner of IC-DISC is an individual, the 15% tax rate on IC-DISC dividends should apply, even if there is no treaty benefit.

Jerry Ogle, Ogle International Tax Advisors

COMPLIANCE AND REPORTING BY IC-DISCs

Ogle International Tax Advisors offers IC DISC consulting services. In addition, our spectrum of international tax services can provide assistance in the areas of :

❖ **Foreign business investments** -

structure active business investments in offshore subsidiaries to minimize U.S. and host country taxation. Analysis of the U.S. CFC and PFIC rules for individual investors.

❖ **Offshore profits importing** -

plan for the repatriation of active foreign profits.

❖ **Foreign tax systems** -

analyze host country deductions, exemptions, and incentives, including foreign tax credits with host country tax advisors.

❖ An IC-DISC can act as a buy-sell entity or a commission-based entity.

❖ In any event, the transfer price between the IC-DISC and related supplier must be calculated under one of the three following methods:

➤ 4% gross receipts

➤ 50% combined taxable income (CTI)

➤ Sect. 482

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Pricing Rules

- ❖ Under both the 4% gross receipts and 50% CTI methods, the DISC does not need to perform any economic functions or have any employees.
- ❖ Under both the 4% gross receipts and 50% CTI methods, the DISC can increase its commission by 10% of its export promotion expenses (EPEs), if the DISC is a buy-sell DISC vs. a commission DISC [Reg. 1.994-1(a)(2) and Computervision Corp v. Comm (96 T.C. 652)].
- ❖ EPEs include general administrative and selling expenses, certain freight paid to U.S.-flagged carriers, packaging costs, and design and label costs for export products incurred by the DISC.
- ❖ *(Note: EPEs paid by a related party can qualify, if a contract existed between the related party earmarking the EPEs for the buy-sell DISC before the transaction took place.)*

Pricing Rules

- ❖ The pricing method chosen is required on a transaction-by-transaction basis (TxT); however, an annual election can be made to group transactions in accordance with products or product lines.
- ❖ Neither the gross receipts method nor the CTI method may be applied in a way that causes, in any taxable year, a loss to the related supplier. There is a special rule that allows the 4% gross receipts method to apply where the overall profit percentage is not exceeded [Reg. 1.994-1(e)(1)(ii)].

Pricing Rules

- ❖ When utilizing the CTI method, overhead costs generally are allocated between export and domestic sales, based on detailed rules [Reg. 1.861-8].
- ❖ However, if the profit margin on export products is less than profit margin on worldwide sales of the same products, then marginal costing rules may be applied to allocate only marginal or variable costs against export receipts under the CTI method [Reg. 1.994-2].
- ❖ Overall, the CTI method generally produces a larger benefit than the gross receipts method, when exports have a greater-than-8% profit ratio.

Sample Commission Calculation

Related Supplier Income Statement Before IC DISC Commission		
Domestic Sales	300	
Export Sales	100	
Domestic COGS	(150)	
<u>Export COGS</u>	<u>(50)</u>	
GP	200	
<u>Overhead</u>	<u>(100)</u>	
Taxable Income	100	25%

Continued - Sample Commission Calculation

DISC Commission Calculation		
Method	4%	CTI
Export	100	100
COGS		(50)
<u>GP</u>		<u>50</u>
Overhead		(25)
Net Income		25
<u>Total Commission</u>	<u>4</u>	<u>12.50</u>

- ❖ Initial IC-DISC election is made on Form 4876-A within 90 days of the start of the taxable year (must be signed by all shareholders).
- ❖ A Form 1120 IC-DISC is required to be filed annually on or before the 15th day of the ninth month following the close of the tax year.
 - Attached will be Schedule K, Shareholder's Statement of IC-DISC Distributions (indicates actual and deemed distributions that are taxable)

- ❖ A Form 8404 must be filed by all IC-DISC shareholders on or before the original due date of their tax returns (no extensions are permitted).
 - Form 8404 requires any deferred interest-related costs to be paid (estimated tax payments are not required on a quarterly basis).
 - Deferred interest is calculated on hypothetical tax based on ordinary rates vs. qualified dividend rates.
 - Form 8404 anticipates that estimates are likely needed, and amended procedures are outlined in form instructions.
- ❖ *Various states have different state income tax filings required.*

- ❖ The DISC must make an initial estimate of the commission at the end of the year, and the related supplier must pay the commission within **60 days** of the close of the year [Reg. 1.994-1(e)(3)(i)].
 - Reasonable estimate requires at least 50%
 - Payment should generally be in cash to avoid non-compliance risk [TSI, Inc. v. US (977 F.2d 424) and Thomas Int'l Ltd v US (773 F.2d 300)].
 - True-up commission requires payment in **90 days**.

- ❖ Failure to optimize available methods such as TxT, marginal costing, overhead allocation under CTI, EPE and factoring of qualified export-related accounts receivable [Rev. Rul. 75-430]