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Interest Charge - Domestic International Sales Corporation ("IC-DISC") - The Export Tax Incentive

Presented by David D. Jones, CPA, Partner, GreerWalker LLP

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IC-DISC

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- Commission DISC is a “paper” company set up by an exporter to collect commissions on export sales
- Commissions are deductible to operating company and are non-taxable to DISC
- Benefit of deduction at ordinary income federal tax rate
- DISC pays dividend taxed to owner(s) at reduced qualified dividend federal tax rate

History

- 1971 - DISC* established
- 1984 - IC-DISC established
- 1984 - FSC* established
- 2000 - ETI* established
- 2003 - Enactment of qualified dividend tax rate

*Each of these were repealed when challenged by EU as allegedly violated GATT (general agreement on tariffs & trade).

History (cont)

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- 2006 - IRS aware of IC-DISC savings
- 2006 & 2007 - Proposals in Congress to eliminate IC-DISC savings
- 2013 - Individual maximum tax rate increases to 39.6% and maximum LTCG rate to 20%
  - Qualified dividends remain in law and tied to LTCG rate
  - Net investment income tax of 3.8% imposed

Eligibility Requirements

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- Manufacturers, Producers, Growers, Extractors and Distributors of US export property may qualify
- Engineers or Architects with jobs outside the US may also qualify

Eligibility Requirements (cont)

- US export property is property that
  - is manufactured, produced, grown or extracted ("MPGE") in the US by a person or entity other than the DISC;
  - is held primarily for sale, lease or rent outside the US; and
  - not more than 50% of the fair market value of the property is attributable to articles imported into the US.

Eligibility Requirements (cont)

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- Property is MPGE in the US if it meets one of the following tests
  - Substantial transformation
  - Facts and circumstances
  - 20% conversion costs

Eligibility Requirements (cont)

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- Property is held primarily for sale, lease or rent outside the US if
  - the sale is a direct export; or
  - the sale is delivered within the US but subsequently exported with no further US use; and
  - Ultimate use is not in the US.

Eligibility Requirements (cont)

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- $2,500 par value single class of stock
- 95% of receipts must be qualified export receipts
- 95% of assets at year end must be qualified export assets

Qualified Export Receipts

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- Commissions on
  - sale or lease of export property
  - services related to sale or lease of export property
  - receipts from engineering or architectural services for construction projects located outside the US
- Interest earned on any qualified export asset

Qualified Export Assets

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- Commission receivable if paid within 60 days of year end
- Cash not in excess of working capital needs
- Customer A/R
- Producer loans
- Stocks and securities of related foreign export corp
- Certain financial assets (ex PEFCO paper)

Formation

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- Consultation to determine applicable sales, expected benefit and recordkeeping requirements
- State tax implications
- C Corporation elects to be an IC-DISC
  - Form 4876-A
  - File within 90 days of formation
- Drafting of articles of incorporation of C Corporation and commission agreement
- $2,500 par value single class of stock
- Establish bank account

Ongoing Costs & Maintenance

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- Consultation regarding annual commission calculation
- Consolidation of GAAP financials
- Preparation of 1120-IC-DISC tax return due September 15th each year for calendar year entity
- Ongoing maintenance of books and records
- Bank fees and account maintenance
- Maintain $2,500 of capital each day of tax year

IC-DISC Commission

- Commission equal to 4% of gross receipts or 50% of combined taxable income
  - If net margins are more than 8% then combined taxable income method is more favorable
  - Can analyze by company, product line or transaction
- Non-taxable to DISC for federal tax purposes
  - No limit on the amount of non-taxable commission to the DISC
  - However, deferral limited to $10M
  - Deferral in excess of 1 year requires interest charge payment

4% Method Example

Jamie w/ No DISC	OpCo		Jamie w/ DISC	OpCo	DISC	Combined
Gross Receipts	$20M		Gross Receipts	$20M	$200K	
NI before Comm	$1M		NI before Comm	$1M		
DISC Comm	0		DISC Comm	($200K)		
NI/Dividend	$1M		NI/Dividend	$800K	$200K	$1M
Tax Rate	40%		Tax Rate	40%	23.8%	
Tax	$400K		Tax	$320K	$47.6K	$367.6K

OpCo is an S Corporation owned 100% by Jamie who is a high net worth individual. OpCo's total gross receipts equal $20M, $5M of which are foreign gross receipts and net income ("NI") on foreign gross receipts is $250K. DISC commission is $200K ($5M * 4%). Net margins of OpCo are 5%. Federal tax savings are approx $32.4K.

50% Method Example

Jamie w/ No DISC	OpCo		Jamie w/ DISC	OpCo	DISC	Combined
Gross Receipts	$20M		Gross Receipts	$20M	$500K	
NI before Comm	$4M		NI before Comm	$4M		
DISC Comm	0		DISC Comm	($500K)		
NI/Dividend	$4M		NI/Dividend	$3.5M	$500K	$4M
Tax Rate	40%		Tax Rate	40%	23.8%	
Tax	$1.6M		Tax	$1.4M	$119K	$1.519M

OpCo is an S Corporation owned 100% by Jamie who is a high net worth individual. OpCo's total gross receipts equal $20M, $5M of which are foreign gross receipts and net income ("NI") on foreign gross receipts is $1M. DISC commission is $500K ($1M * 50%). Net margins of OpCo are 20%. Federal tax savings are approx $81K.

Advanced Planning

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- Alternate ownership structures
  - Estate planning via children owning DISC
  - Individual partner with applicable K-1 income where partnership does not want DISC
- Operating activity in favorable state
- Increase commission
  - Reimburse expenses
  - Pay export promotion expenses directly from DISC
  - Use transaction by transaction analysis
- Tax deferral
  - Leave applicable earnings in DISC to defer taxation of dividends to shareholders of DISC
  - Create high margin income to defer up to $10M limit

Thank You for Attending

David D. Jones, CPA

GreerWalker LLP

david.jones@greerwalker.com

704-353-8264