HOW TO SAVE AND/OR DEFER TAXES THROUGH EXPORT OPERATIONS - UTILIZATION OF AN IC-DISC

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I. History of Domestic International Sales Corporation (DISC)

    A. Birth in 1971

    B. Threatened termination in 1976

    C. Termination in 1984

    D. Birth of IC-DISC

    E. Present status

II. History of Foreign Sales Corporation (FSC)

    A. Birth in 1984

    B. Termination in 2000

III. Requirements of DISC

    A. U.S. corporation

    B. One class of stock

    C. Minimum capitalization of $2,500

D. Election

1. File within 90 days after beginning of first taxable year

2. Thereafter file any time during 90 day period prior to beginning of year

E. Gross receipts must consist of at least 95% qualified export receipts

F. Adjusted basis of assets at year-end must consist of at least 95% qualified export assets

IV. Operation of DISC

A. Buy - sell arrangement

1. More difficult to administer

2. More costly to administer

B. Commission arrangement

1. Execute sales representation agreement between DISC and its related exporter

2. Determine commission due DISC within 60 days after year end

3. Pay commission to DISC within 60 days after year end

C. Qualification

1. DISC required to maintain qualification in order to continue status

a. Qualified Export Receipts

b. Qualified Export Assets

c. If failed, can be corrected with a dividend distribution

D. Reporting

1. Form 1120-IC-DISC, along with Schedule K

2. Form 8404, with which the interest charge on deferred taxes is paid

V. Determine what to do with Funds

A. Loan to exporter

B. Dividend to shareholders

1. Qualified dividend; eligible for applicable long-term capital gain rate; perhaps subject to “net investment” tax

2. If exporter is a C corp. and individuals own DISC, can pay tax-deductible dividends

a. C corp. pays commission and receives deduction (34%)

b. DISC pays dividend and individual shareholders pay tax (LTCG Rate)

3. If exporter is a flow-through entity (35% or 39.6% tax rate), dividend essentially converts ordinary income to income subject to long-term capital gain rate (perhaps subject to net investment tax)

VI. Determine who should own

A. Related exporter (parent-subsidiary)

B. Exporter’s shareholders

C. Exporter’s shareholders’ children

D. Trust for exporter’s shareholders’ children

E. Individual retirement account (IRA)

1. See *Swanson v. Commissioner*, 106 TC 76 (1996) and *Hellweg v. Commissioner*, T.C. No. 14502-08, T.C. Memo. 2011-58, March 9, 2011

2. See also §995(g), which creates unrelated business taxable income if a DISC pays a dividend directly to an IRA, or other tax-exempt entity

3. Due to §995(g), a C corporation may be interposed between the IRA and the DISC

4. Care must be taken to avoid prohibited transactions

F. Roth IRA

1. See above under IRA

2. See also Notice 2004-8, which may require disclosure on Form 8886 for various persons/entities within the organizational structure

G. Key employees

H. Gift question

VII. Structure of DISC Depends on Goals

A. Defer Taxes and Maintain Cash

1. Parent-subsidiary with loan from DISC to exporter

2. DISC owned by exporter's owners or next generation; funds loaned to exporter

B. Reduce Taxes and Maintain Cash

1. Parent-subsidiary <u>if</u> exporter is a flow-through entity

a. Exporter deducts commission (ordinary income tax rate)

b. DISC distributes commission as a dividend (long-term capital gain tax rate)

c. Exporter retains cash

2. If exporter is a C corporation, DISC can be owned by exporter's owners or next generation

a. Exporter deducts commission (34% tax rate)

b. DISC distributes commission as a qualified dividend

c. DISC's shareholders loan after-tax funds to exporter, or contribute as an equity injection

C. Reduce Taxes; Funds NOT Needed By Exporter

1. DISC owned by exporter's owners/next generation of exporter's owners/key employees

   a. Exporter deducts commission (ordinary income tax rate)

   b. DISC distributes commission as a dividend (long-term capital gain tax rate)

   c. Key employees receive incentive/bonus income without payroll withholding and at long-term capital gain tax rate

D. Retirement Funding

1. DISC ultimately owned by IRAs/ROTH IRAs

   a. Exporter deducts commission (ordinary income tax rate)

   b. DISC distributes commission to intervening C corporation (to avoid UBTI in IRA/ROTH IRA); corporation pays taxes (ordinary income tax rate)

   c. Corporation distributes after-tax funds to IRA/ROTH IRA