Last Chance for Export Tax Incentives?

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The Interest Charge Domestic International Sales Corporation (hereafter referred to as an IC DISC corporation or company) came back in vogue in the international tax world in 2006 as the Extraterritorial exclusion was being phased out of U.S. tax legislation in the aftermath of an era of foreign sales corporations (FSCs) in the 1980s and 90s.

The thing that fueled the IC DISC was the qualified dividend tax legislation that had been passed in 2003. That legislation is scheduled to expire at the end of 2012 so this may be the last opportunity to take advantage of export tax incentives for those eligible taxpayers who have not yet done so.

The qualified dividend legislation was originally scheduled to expire at the end of 2008 but was extended through December 31, 2010. Near the close of 2010, the legislation was again extended until December 31, 2012. While the legislation may yet be extended into 2013, taxpayers should be prepared in case this is the last opportunity to claim IC DISC benefits.

Who is eligible?

Taxpayers that sell export property must meet various tests to qualify for export tax incentives including a content test, a substantial transformation test and a destination test. Once it is determined that a taxpayer meets these tests and is eligible for export tax incentives, it must form a corporation, elect IC DISC treatment and enter into an IC DISC commission agreement.

Manufacturers that export property who are already obtaining tax benefits in the form of the Domestic Production Activities Deduction (DPAD) which was designed to replace the Extraterritorial exclusion for manufacturers will reap enhanced tax savings if they also form an IC DISC corporation.

Content test

To meet the content test, the fair market value of the export property that is being sold must not be more than 50 percent attributed to imported items that were manufactured outside of the United States. The value of those imported items is based on the value declared for customs purposes. As long as that customs value is less than 50 percent of the sales price of the export property, the taxpayer should satisfy the content test.

For example if a taxpayer sells a widget for $100 and the costs of the imported raw materials that went into that item when it was imported (also the value declared for customs purposes) were $35 then the taxpayer should satisfy the content test as long as there was substantial transformation in the United States.

Substantial transformation or conversion cost test

To ensure that export property underwent real manufacturing processes within the United States, a substantial transformation or conversion cost test must be met. The substantial transformation test is

generally met when the product produced represents an irreversible process that cannot be converted back into the raw materials. The conversion cost test is met when the manufacturing costs within the United States (cost of converting the raw materials into finished goods) exceeds 20% of the total cost of goods sold with respect to the product.

In our example above, if labor costs (conversion costs) were $10 for manufacturing the raw materials into a widget, then the conversion cost test would be met since the labor costs would exceed 20% of the total cost of goods sold of $45.

Destination test

In order to satisfy the destination test, the ultimate destination of the export property must be outside of the United States. It should be noted that Possessions of the United States, such as Puerto Rico are not considered outside of the United States for this purpose, even though they are considered foreign locations for other U.S. tax purposes.

To continue our example, if the widget once manufactured has been sold to a distributor who will then resell the product to a customer in a foreign location, both the manufacturer and the distributor can claim export tax incentives if they have an IC DISC in place. Even though the immediate destination of the product is within the United States after it leaves the manufacturing facility, since the ultimate destination is outside the United States, the manufacturer can still claim export incentives as long as the distributor sells the product to a customer in a foreign location and delivers that product within one year after purchasing the product from the manufacturer.

How does it work?

The exporting company sells the product to the overseas company at a profit. The exporting company then pays a commission to the IC DISC which is then deductible for tax purposes. The IC DISC is a tax exempt corporation so it pays no tax on the commission. It must satisfy a gross receipts test and an asset test relative to its exporting activities.

There are certain election procedures as well as shareholder restrictions, but the IC DISC corporation is generally owned by the shareholders of the related export company.

What are the benefits?

The export company claims a deduction for the IC DISC commission and reduces its tax liability at its maximum tax rates. The IC DISC corporation then pays a dividend to its shareholders. The dividend is subject to more favorable tax rates applicable to qualified dividends, resulting in substantial tax savings to the shareholders.

What if the qualified dividend legislation expires at the end of 2012?

An IC DISC can still be formed to claim export tax incentives for the remainder of 2012. There have been many cases where IC DISC tax benefits for just one month's worth of export activity substantially exceed the cost of forming the IC DISC company and setting up a tax efficient structure.

Many companies were still forming IC DISC companies in November and December of 2010 when it was expected that the legislation was going to expire on December 31, 2010 because they had large shipments of products scheduled to leave the country for customers in foreign locations before the end of the year. The opportunity for 2012 is the same as it was for 2010 and there may still be time for form the IC DISC corporation, but time is of the essence. If the legislation is extended into 2013, those taxpayers who form IC DISC companies this year to obtain tax benefits for the balance of 2012 will already be positioned for sustained export tax incentives into the succeeding year.