Chapter 1

# Overview of U.S. Corporate International Taxation

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## Learning objectives

- Recognize the comprehensive system of outbound (core) and inbound U.S. international taxation laws.
- Recognize the concepts of timing for income recognition.
- Identify the international tax provisions of the Tax Cuts and Jobs Act (TCJA) signed in December 2017.
- Recognize U.S. federal income tax benefits for U.S. exporters of U.S. property under the interest charge domestic international sales corporations (IC-DISC) regime.

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# Summary

This course will cover the fundamentals of U.S. corporate international taxation, with a primary focus on "outbound concepts" and technical tax issues. This course has been updated to cover the fundamental international tax provisions within the TCJA, including for international tax Treasury Regulations and Notices released through March 2019.

In general, the United States taxes *U.S. persons* on their worldwide income. The United States may grant the functional equivalent of an exclusion through a foreign tax credit or tax deduction. For example, under Section 936, a domestic corporation may offset hypothetical U.S. taxes on certain income connected with U.S. possessions against U.S. taxes that otherwise would be due.

Section 7701(b) contains methodical rules to define when an alien is a U.S. resident. Mere presence in the United States for 183 days in a taxable year may subject an alien to taxation on worldwide income for that year. In general, a domestic corporation, which is subject to U.S. taxation on worldwide income, is a corporation incorporated in the United States. In certain narrow cases, however, the Internal Revenue Code (IRC) may treat a foreign corporation as domestic or treat a branch of a domestic corporation as foreign.

In general, a U.S. person that incurs foreign losses may deduct those losses for U.S. tax purposes. However, the deduction of a dual consolidated loss may be limited. Further, recapture rules may trigger income in a taxable year after a foreign loss.

Because the United States generally taxes U.S. citizens and residents on worldwide income, the issue of double taxation may arise when such a person has income from foreign countries or U.S. possessions. To reduce the problem, the United States generally grants a foreign tax credit for income taxes paid to foreign countries and U.S. possessions. Section 904 contains complex rules regarding the foreign tax credit, and its limitations may severely limit the actual use of the credits.

The United States does not automatically tax a U.S. person on the income of a foreign corporation that is owned in whole or in part by that person. Therefore, U.S. persons may form a foreign corporation to conduct foreign activities without incurring U.S. taxes before receipt of distributions from the corporation or a sale of the corporation's stock. However, Congress and the U.S. Treasury have adopted rules, regulations, notices, and significant annual reporting requirements for controlled foreign corporations (CFCs) and passive foreign investment companies (PFICs), in addition to foreign disregarded entities, foreign branches, or qualified branch units (QBUs), and foreign partnerships.

The United States has entered into tax treaties and conventions with many foreign countries. In general, those treaties affect the U.S. taxation of foreign persons, not U.S. persons. The "Saving Clause" in each treaty generally gives the United States the right to tax its corporations, citizens, and residents as if the treaty had never come into force. In certain cases, a tax treaty may limit the U.S. taxation of U.S. persons. Examples of such help for U.S. citizens and residents include (*a*) the allowance of U.S. foreign tax credits, with special source rules for purposes of Section 904; (*b*) tax treaty or protocol clauses that prevent discriminatory treatment of foreign persons that are U.S. residents and of domestic corporations owned by foreign persons; (*c*) exemptions for certain types of income; (*d*) the allowance of certain deductions; and (*e*) the use of competent authority procedures (for example, mutual agreement procedures or "MAP") to resolve inconsistent treatment by the United States and the foreign treaty country.

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# U.S. Outbound Tax Concepts

- Exporting U.S. products to foreign countries
- Exporting or performing services to foreign persons outside the United States
- Foreign branch of a U.S. business — Section 987
  - Section 987 may apply when the U.S. taxpayer operates in a branch form (such as a check-the-box foreign disregarded entity or a foreign partnership) and such branch is a QBU with a functional currency different than that of its owner.
- New benefits and tax provisions available only to C corporations under the TCJA
- Subpart F income from CFCs
- global intangible low-taxed income (GILTI) from CFCs
- Dividends Received Deduction (DRD) or Participation Exemption applicable for C corps that own at least 10% of a foreign corporation — Section 245A
- Investment in U.S. property by a CFC — Section 956
- Section 863(b) sourcing rules modifications
- Foreign tax credits (FTC)
  - Direct foreign tax credit, Section 901
  - Indirect or deemed-paid credit, Section 902 (repealed by the TCJA)
  - Allowable credit calculated on Forms 1118 (corporate) or 1116 (individual)
- Limitation on FTC, Section 904
- U.S. shareholders of PFICs
- Limits on interest expense for U.S. businesses (that is, 30% of adjusted taxable income [ATI])

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## Knowledge check

1. Section 987 addresses which issue?

   a. Currency translation values at the time of a transaction.
   b. Character of gain or loss.
   c. Foreign branches that are QBUs.
   d. Transfer pricing.

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# U.S. Inbound Tax Concepts

- Investment or passive types of income from U.S. sources (for example, fixed, determinable, annual, or periodical [FDAP]) — Sections 871 and 881
- Effectively connected income (ECI) derived from a U.S. trade or business (ECI from a U.S. trade or business) — based on IRC, U.S. case law, and IRS rulings
- Business profits attributable to a U.S. permanent establishment (PE) — based on U.S. tax treaties and conventions
- Interest expense limitation or the thin capitalization and anti-earnings stripping rules, Section 163(j)
- Debt versus equity U.S. tax law
- Foreign Investment in Real Property Tax Act (FIRPTA) — the disposition of a U.S. real property interest by a foreign person (the transferor) is subject to U.S. source withholding tax. FIRPTA authorized the United States to tax foreign persons on dispositions of U.S. real property interests. Sections 897 and 1445. PATH Act revisions
- Base erosion and anti-abuse tax (BEAT) — Section 59A
- Modified Section 1446(f) and new Section 864(c)(8) reverses the holding within the *Grecian Magnesite Mining* case, and reverts to the original holding in Rev. Rul. 91-32 for U.S. income tax treatment of foreign partners who sell their interest in an *operating* U.S. partnership (that is, a U.S. partnership that has ECI from engaging in a U.S. trade or business)

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# Other fundamental U.S. international tax concepts

- Choice of entity classification, U.S. “check-the-box” rules
  - Section 7701, and Treasury Regulation 301.7701-1, -2
  - U.S. tax law governs the classification of a form of foreign business organization for U.S. tax purposes. The check-the-box regulations under Section 7701, generally effective January 1, 1997, provide that any “business entity” that is not required to be treated as a corporation is an “eligible entity” that may choose its classification. The regulations provide default classification rules. Eligible entities may elect out of the default rules. Entities that wish to change their previous classification must also do so by filing an election that qualifies for purposes of Section 7701.
  - Form 8832 is known as the “check-the-box” election form, or the entity classification election form.
- Sourcing of income and (allocation of) expenses
- Tax treaties and conventions
  - Tax treaties generally reduce withholding tax rates between Treaty partner jurisdictions and contain provisions that allow for procedures to avoid double taxation on one item of income by the same taxpayer by two different taxing jurisdictions and or States.
- Transfer pricing rules — intercompany or related party transactions, Section 482
  - Requires an arm’s length price or rate on an intercompany or related party transaction under Section 482, Treasury Regulations under Section 482, and Organization for Economic Co-operation and Development (OECD) rules.
  - OECD’s base erosion and profit shifting initiative
  - Country by Country (CbC) reporting
- U.S. statutory *withholding* tax rules for FDAP income under chapter 3 (regular) and chapter 4 (FATCA for financial services industry) of the IRC

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# International tax fundamental concepts

## Definition of “U.S. person”

The term "United States person" means

- a citizen or resident of the United States;
- a partnership created or organized in the United States or under the law of the United States or of any State, or the District of Columbia;
- a corporation created or organized in the United States or under the law of the United States or of any State, or the District of Columbia;
- any estate or trust other than a foreign estate or foreign trust. (See IRC Section 7701(a)(31) for the definition of a foreign estate and a foreign trust); or
- any other person that is *not* a foreign person.

A foreign person includes a nonresident alien individual (NRA), foreign corporation, foreign partnership, foreign trust, a foreign estate, and any other person that is not a U.S. person. It also includes a foreign branch of a U.S. financial institution if the foreign branch is a qualified intermediary. Generally, the U.S. branch of a foreign corporation or partnership is treated as a foreign person. A nonresident alien is an individual who is not a U.S. citizen or a resident alien. A resident of a foreign country under the residence article of an income tax treaty is an NRA for purposes of U.S. withholding tax.

U.S. citizens, resident aliens, corporations, and fiduciaries are generally taxed on their export income in the same manner as on their domestic income from the United States.

U.S. businesses report income and deductions from export activities on the same tax returns used to report income from domestic sales. However, there are two significant differences:

1. Income may be considered earned by a U.S. business for purposes of U.S. taxation even though exchange or capital controls imposed by foreign governments restrict the ability of the business to use the proceeds of the export sale.
2. There are particular forms and schedules to be completed that reflect specific issues that arise only in international transactions.

### Example 1-1

Sessions Corporation, a financial services company, incorporated and headquartered in the United States, opens a trading office in Sao Paulo, Brazil. Sessions office in Sao Paulo attracts investment from several large Brazilian investors. Sessions collects commissions for these sales but is not allowed to return its commissions to the United States due to a currency control recently imposed by the Central Bank of Brazil. Sessions must nevertheless report the Brazilian commissions on its U.S. federal income tax return, absent an election to file a separate U.S. Form 1120 for blocked income.

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## Knowledge check

2. When a U.S. business has commission sales in country X but cannot remit the sales commissions to the United States due to currency control regulations in X, the U.S. business must recognize income

   a. When the sales commissions are remitted to the United States.
   b. On its U.S. federal income tax return.
   c. In an amount equal to 50% of the sales commissions.
   d. In an amount equal to 75% of the sales commissions.

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# Recognition of income

In general, businesses are considered to recognize income and are required to report the income for tax purposes when the business receives the income, accrues the income under generally accepted accounting principles, or has the right to obtain the income.

## Time of payment

Generally, income is recognized when received or accrued. Recognition of income may take place earlier than actual receipt; however, when funds are deposited in a bank account in the name of the business or otherwise made freely available to the business. Similarly, recognition of income may take place later than actual receipt if the funds are subject to future contingencies.

A business may recognize income even though payment is made to another company. The determination of whether the recipient is acting solely for the business depends on whether the recipient is a real entity engaged in a real transaction.

### Example 1-2

Assume in example 1-1, that Sessions Corporation incurs a significant net operating loss in its Sao Paulo office and earns a substantial commission rendering services in the United States. Before collecting the commission, Sessions transfers the commission contract to its Brazilian subsidiary to shelter the commission income earned in the United States with the Brazilian loss. Upon examination of Sessions' U.S. tax return, the IRS will include the U.S. commission in Sessions' U.S. tax return.

U.S. businesses are on the cash method of accounting with respect to amounts owed to a related foreign person except where the related foreign person is a CFC, a passive foreign investment company or a foreign personal holding company, in which case the U.S. business can deduct accrued amounts as of the day on which a corresponding amount of income is recognized by the CFC, the passive foreign investment company or the foreign personal holding company.

Effective October 22, 2004, accrued but unpaid amounts due from a U.S. business to a related CFC or passive foreign investment company cannot be deducted by the U.S. business until a corresponding amount is included in the gross income of a U.S. person(s) who owns stock, directly or through a foreign entity, in the CFC or the passive foreign investment company.

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### Example 1-3

Assume in example 1-1, that Sessions Corporation takes a working capital advance from its Sao Paulo office. The working capital advance to the U.S. office is documented in a promissory note and bears interest at a market rate. Sessions U.S. accrues a quarterly interest payment to its Sao Paulo office on December 31, the end of Sessions U.S. tax year and pays the amount accrued January 10 of the following tax year. Sessions U.S. cannot deduct the interest payment accrued but not paid December 31 until actually paid in the subsequent tax year.

## Delivery of goods

In some situations, a U.S. business will recognize income when goods are delivered to a foreign person. If the purchaser makes advance deposits with the seller or the purchaser pays with an irrevocable letter of credit, delivery of the goods may trigger recognition of income to the U.S. business. However, if the U.S. business ships goods on consignment to a foreign dealer, the U.S. business will recognize income after the goods are sold by the dealer.

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# Introduction of International Tax Provisions enacted by the TCJA

## Select *general* tax provisions of the TCJA

The TCJA provisions affect tax years beginning in 2018, with some exceptions.

- A permanent 21% corporate income tax rate effective in 2018, representing a 40% decrease over the prior corporate income tax rate of 35%
- Limitations on business and personal net operating losses and business interest deductions
- Repeal of the corporate alternative minimum tax (AMT)
- Repeal of the domestic production activities deduction (DPAD)
- New broader interest expense limitation regulations under Section 163(j) that limit interest expense to 30% of Adjusted Taxable Income (ATI)
- A 20% deduction for qualifying pass-through income from partnerships, LLCs, and S corporations; notable exceptions (SSTBs) that do **not** qualify are in consulting, accounting, law, healthcare and medicine, and related fields — The "pass-through deduction" for up to 20% of Qualified Business Income of U.S. pass-through business entities under Section 199A (generally requires W-2 employee expense) that require modeling between the effective tax rate of a pass-through entity versus a C corp entity.
- Revisiting the technical rules surrounding the Accumulated Earnings Tax (Sections 531, 532) and Personal Holding Company Tax (Sections 541-543) for C corporations

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# Introduction and listing of U.S. international tax provisions

## One-time repatriation tax on accumulated foreign subsidiary's earnings, Section 965 "transition tax"

- The TCJA imposes a one-time tax on a 10% or greater U.S. shareholder's share of the accumulated and previously untaxed foreign earnings and profits of specified foreign corporations (SFCs). SFCs are defined as CFCs and other foreign corporations having a domestic corporate shareholder with at least 10% ownership. The post-1986 accumulated earnings of all SFCs will be treated as an increase to current-year Subpart F income and mandatorily deemed repatriated to their "U.S. shareholders."
- Repatriated earnings held in cash and cash equivalents will be taxed at a 15.5% rate, and the remaining amount of earnings held in illiquid assets will be taxed at an 8% rate. For 10% U.S. C corporation shareholders, a proportional, partial foreign tax credit is allowed.
- The amount of accumulated foreign earnings and profits subject to mandatory repatriation will be determined as of November 2, 2017, or December 31, 2017, whichever is greater. The first installment (or the entire amount) is due by the original due date of the tax return filed for the last tax year beginning before January 1, 2018, without regard to extensions. For calendar-year filers, this would be the tax year beginning January 1, 2017, and ending December 31, 2017, which means that the first installment (or the entire amount) was due April 17, 2018.
- For S corporations subject to the deemed repatriation tax, there is a special provision that defers the tax until the S corporation sells substantially all of its assets, ceases to conduct business, changes its tax status, or the electing shareholder transfers its stock.

## U.S. base erosion provisions — "BEAT," Section 59A (inbound tax provision)

- The BEAT is an alternative minimum tax on corporations that have annual gross receipts for the three prior years of at least $500m and that make certain "base erosion" payments to foreign related parties in excess of a threshold amount.
- Base erosion payments include amounts paid or accrued to a foreign related party that are deductible against U.S. taxes, such as interest, royalties, and service fees (but do not include costs of goods sold).
- The BEAT tax rate is 5% for tax years beginning in 2018, 10% for tax years 2019 through 2025, and 12.5% for tax years beginning after 2025.
- A further base erosion provision also applies to deny a deduction for certain payments of interest and royalties to related parties either pursuant to a hybrid transaction, whereby the characterization of the payment differs between U.S. and foreign tax law, or by or to a hybrid entity (a foreign disregarded entity) where the payment is not included in income by the related party.
- Base erosion provisions are modified to clarify that dividends received by an individual from a surrogate foreign corporation as a result of an inversion transaction are not qualified dividends and, therefore, are not eligible for the lower qualified dividend rates.

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## Global intangible low-taxed income, Sections 951A and 250

- Summary: minimum (that is, generally 10.5% to 13.125%) U.S. income tax on CFC's annual, computed income, determined after Subpart F income
- The effect of the GILTI provision is to subject U.S. shareholders of CFCs to current taxation on the aggregate net income of the CFCs over a routine return.
- The GILTI provision applies to the tax years of a CFC that begin after December 31, 2017, and to U.S. shareholders of such CFC in which or with which such tax years of the CFC end.
- U.S. corporate shareholders of CFCs (but not individuals, partnerships, or S corporations) are allowed to deduct 50% of GILTI for tax years beginning after December 31, 2017, and before January 1, 2026, and 37.5% of GILTI after 2026.
- U.S. corporate shareholders of CFCs can also claim a foreign tax credit with respect to included GILTI amounts, but such foreign tax credit is limited to 80% of the foreign tax paid, and any unused FTCs cannot be carried forward or carried back to other tax years.
- U.S. *individual* shareholders of CFCs that implemented the Section 962 election pursuant to the Regulations released in 2019, (*a*) will also be allowed to deduct 50% of GILTI for tax years beginning after December 31, 2017, and before January 1, 2026, and (*b*) may claim a foreign tax credit with respect to included GILTI amounts, but such foreign tax credit is limited to 80% of the foreign tax paid, and any unused FTCs cannot be carried forward or carried back to other tax years.
- The objective or hope was for the U.S. Treasury to impose an effective tax rate (ETR) of 10.5% to 13.125% on each CFC's annual income (subject to complex regulatory computations), to the U.S. shareholders.

## Foreign-derived intangible income, Section 250

- As an incentive to keep intangible assets, functions, and activity inside and originating in the United States and also encourage U.S. export activity, a U.S. C corporation is allowed to deduct 37.5% of its foreign-derived intangible income (FDII) for taxable years beginning after December 31, 2017, and before January 1, 2026. For taxable years beginning after December 31, 2026, the FDII deduction is reduced to 21.875.
- FDII of a U.S. corporation is generally the excess of its gross income over deductions properly allocable to such income, to the extent such income is derived in connection with the sale of property to a non-U.S. person for a foreign use, or services provided to any person (or with respect to property located outside the United States) located outside the United States.
- The objective or hope was for the U.S. Treasury to impose an ETR of 13.125% on qualified FDII of C corporations. However, tax rate modeling and detailed tax computations have shown that such an ETR will not always be the result. At times, it can be higher.
  Compare the existing IC-DISC regime that benefits non C corps, such as individuals, S corps, partnerships, and LLCs that primarily export tangible property of at least 50% U.S. component or origin.

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## Quasi-territorial system of taxation of U.S. C corporations, Section 245A

- Known as the DRD or Participation Exemption
- Subpart F and Section 956 are still in effect and Regulations address the coordination of the rules
  - Subpart F must be considered and included before Section 245A and 951A
  - Section 956 may be eliminated or mitigated with 245A DRD
- U.S. C corporations that own 10% or more of a foreign corporation (other than a passive foreign investment company that is not also a CFC) shall be entitled to a 100% DRD for the foreign-source portion of dividends received from such corporation.
- Constructive dividends arising from a U.S. corporation's sale or exchange of stock in a foreign subsidiary (held for more than one year) will be treated as a dividend for purposes of the 100% DRD.
- Any foreign taxes attributable to the income that gives rise to the dividend will not be eligible for the foreign tax credit or deduction. There is a holding period requirement that must be met for the dividend to be eligible for the deduction, where the foreign corporation stock must be held for more than 365 days during the 731-day period beginning 365 days before the ex-dividend date.
- All amounts that are eligible for the 100% DRD will reduce the U.S. corporation's basis in the stock of the foreign corporation for purposes of determining loss on the eventual sale of such stock.

## Foreign Tax Credit Regulations and other U.S. international tax provisions

- On March 4, 2019, Proposed Regulations provided that individual U.S. shareholders of CFCs will be eligible to apply a 50% deduction on taxation of GILTI. Individual U.S. shareholders who make the Section 962 election will also be permitted to take the Section 250 deduction with respect to their GILTI inclusion amounts. This treatment should result in individual U.S. taxpayers who choose to make the Section 962 election seeing a decrease in U.S. taxation of their GILTI inclusion amounts from 37% down to (a potential) 10.5%, also subject to further reduction by applicable FTCs. Note that Smith v. Comm'r, 151 T.C. No. 5 (2018) (Tax Court case) found that a "Section 962(d) distribution" from a Hong Kong CFC was not qualified dividend income. Instead, it was subject to ordinary income tax rates.
- The Section 902 deemed-paid foreign tax credit on dividends received from foreign subsidiaries has been repealed.
- There are separate baskets for foreign branch income and GILTI for foreign tax credit purposes.
- The current law 50-50 sourcing rule, for income from the sale of inventory produced partly in and partly outside the United States, has been modified by allocating and apportioning such income solely on the basis of production of that inventory. Therefore, inventory produced entirely in the United States will be 100% U.S.-source income for foreign tax credit purposes, even if title to such inventory is outside the United States.
- A new election is also available for foreign tax credit purposes. Generally, under current law, in situations in which a taxpayer incurs a loss and is limited in regard to claiming a foreign tax credit, U.S.-source income can be recharacterized as foreign-source income in subsequent years in an amount equal to the lesser of the entire amount of such loss that is not carried back or 50% of the taxpayer's U.S.-source taxable income for the succeeding year. For taxable years beginning after December 31, 2017, and before January 1, 2018, taxpayers may elect to compute the percentage-based amount differently if it results in a higher amount.
- Provisions requiring inclusion of foreign base company oil-related income as a category of foreign base company income have been repealed.

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- Provisions requiring inclusion of foreign base company shipping operations income when investments in CFCs decrease have been repealed.
- A change has been made to the CFC attribution rules (that is, repeal of Section 958(b)(4)) such that, in certain situations, stock held in a foreign corporation by a foreign person can be attributed to a U.S. person for purposes of determining CFC status of a corporation (but see Notice 2018-13).
- A change has been made to the definition of a U.S. shareholder to now include any U.S. person who owns 10% or more of the total value of shares of all classes of stock of a foreign corporation, in addition to the current 10% voting stock rule (which means it is easier to become a “U.S. shareholder” of a CFC).
- A change has been made to eliminate the 30-day minimum holding period for determining whether a U.S. shareholder must include the CFC’s Subpart F income (which means it is easier to have or own a CFC).
- Notice 2019-01 and Proposed (Foreign Tax Credit) Regulations replace the former pooling system with intricate rules for calculating foreign taxes incurred by a CFC that are “deemed paid” by a U.S. shareholder, and the respective shareholder’s FTCs. Foreign taxes are eligible to be treated only as deemed paid, and the resulting FTCs are available only to a U.S. shareholder, in respect of Subpart F and GILTI inclusions and distributions of previously taxed earnings and profits (PTEP). With some exceptions, these rules approximate a “tracing” regime under which FTCs are available only to the extent the underlying foreign taxes are attributable to particular items of income giving rise to Subpart F or GILTI inclusions to the U.S. shareholder, or to foreign taxes imposed on distributions of PTEP.
- For purposes of the Section 960(b) credit, the proposed regulations require the shareholder to maintain up to 10 annual accounts of previously taxed earnings and profits and related foreign income taxes (PTEP groups) for each CFC. Recall that, before Section 959(c)(1) and (c)(2), E&P was referred to as PTI; however, the proposed regulations favor the PTEP acronym. The 10 accounts relate to the different types of Section 959(c)(1) and (c)(2) PTI (or PTEP) attributable to different inclusions, such as under Subpart F, Section 965, GILTI and Section 956. PTI in one PTEP group may be reclassified as PTI in another PTEP group as a result of a Section 956 income inclusion (investment in U.S. property).
- The proposed regulations require each PTEP group and related foreign income taxes be maintained in annual layers.

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# U.S. Export Tax Incentive through an IC-DISC

## IC-DISC

With the repeal of the extra territorial income exclusion, the IRS noticed the resurgence of the domestic, international sales corporation (DISC) in the form of an interest charge DISC (IC-DISC). The relevant tax provisions for the IC-DISC are generally within IRC Sections 991 through 996, and corresponding regulations, and is commonly referred to as *the last practical tax incentive for U.S. exporters*. If certain requirements are met under the IRC and the regulations, the IC-DISC may provide U.S. exporters significant benefits including a qualified dividend tax rate versus an ordinary income tax rate, deferral of IC-DISC income from current taxation (up to $10m annual revenue limit), increased cash flow for exporter due to tax savings, a lower ETR, and elimination of double taxation in C corporations.

The IC-DISC is a tax incentive whereby U.S. exporters exporting U.S. products to foreign destinations are able to receive the qualified dividend tax rate currently at 20% plus the 3.8% net investment income tax imposed by Section 1411, for a total of 23.8% maximum federal income tax rate. This is a considerable reduction from the maximum federal income tax rate for individuals currently at 40.8% (maximum federal individual income tax rate 37% plus 3.8% net investment income tax).

The DISC generally determines its income on a transaction by transaction (T by T) basis or if it so elected it could determine income on groups of transactions. Whether it used the T by T method or grouped their transactions, the DISC's income is based on one of the following three pricing methods:

1. Four percent of qualified gross export receipts plus 10% of the DISC's export promotional expenses attributable to such receipts
2. Fifty percent of combined taxable income (CTI) plus 10% of the DISC's export promotional expenses attributable to such income
3. Taxable income based upon the sale price actually charged but subject to the rules under Section 482 transfer pricing rules

| Example — ABCUS company IC-DISC high-level cost-benefit | | | |
|---|---|---|---|
| | | Export earnings without IC-DSIC | With IC-DISC |
| *Standard* | ABCUS 2013 "Taxable" *export* income | $3,600,000 | $3,600,000 |
| | 50% CTI method | $1,800,000 | $1,800,000 |
| | Individual standard & QD rate | 37.00% | 20.00% |
| | After tax cash for owners | $1,134,000 | $1,440,000 |
| | Cash tax savings | | $306,000.00 |

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## Ownership and organizational structure

An IC-DISC is a separate (legal) *C corporation* that acts as a sales commission agent for a U.S. agricultural, food manufacturing, or distributing exporter (the exporting entity). The IC-DISC is by design and by operation of tax law within the IRC *more form* over substance. In the IRS audit guide, it is apparent that the form, including documentation and a completely thorough and accurate IC-DISC [formal] election, are crucial for the qualification and maintenance for the IC-DISC tax beneficial status.

An IC-DISC does not need employees or office space and does not have to perform any services or participate in any sales to earn a commission. The entity is required to maintain a separate set of books and records, including a separate bank account. It may have only one class of stock and must, at all times, have stock outstanding with a par or stated value of at least $2,500. Any type of entity or individual can own an IC-DISC. In most situations, ownership should be held by an individual or flow-through entity (an LLC, partnership, or S corporation) for the greatest tax benefit. If the exporting entity is one of these pass-through entities, the IC-DISC can even be formed as a subsidiary. However, if the exporting entity is a C corporation, the IC-DISC should be set up as a sibling to the exporting entity rather than a subsidiary, and it should generally be owned by the exporting entity's individual shareholders.

Note that the shareholders of the IC-DISC do not need to be the same as the shareholders of the exporting company. An IC-DISC can be used to provide a benefit to key employees or as a tool in estate and or succession planning.

An IC-DISC is also allowed to have foreign shareholders as long as the foreign shareholder agrees that any distribution (actual or deemed) is income effectively connected with a U.S. permanent establishment. The dividends paid from an IC-DISC to its shareholders are generally considered to be foreign-source income. This makes the use of an IC-DISC particularly valuable to U.S. shareholders with passive foreign tax credit carryovers.

## Taxation of an IC-DISC

An IC-DISC is categorized as a domestic C corporation that is tax exempt for federal income tax purposes. However, to obtain this tax exempt status, the corporation must file Form 4876-A, Election to Be Treated as a DISC, within 90 days of its first taxable year. If the corporation elects to be treated as an IC-DISC moving forward, then the election must be made within 90 days before the beginning of the first taxable year of the DISC. The election must be signed by all shareholders as of the effective date of the election. Once made, the election is effective for all subsequent years until it is revoked by the corporation. Based on foreign sales of products manufactured, produced, grown, or extracted in the United States, the exporter pays a commission to the IC-DISC and then deducts the commission from its ordinary business income. This results in a deduction at ordinary tax rates. The IC-DISC receives the commission without having to pay federal tax on the income. In most cases, the IC-DISC then distributes this cash as a dividend to its shareholders. As long as the shareholders are individuals or pass-through entities such as S corporations or partnerships, the dividend is taxed at the favorable qualified dividend tax rates.

For example, say an S corporation hops grower has domestic gross receipts of $25m and foreign gross receipts of $15m for a total of $40m. The cost of growing, harvesting, drying, and bailing the hops —

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which will be sold both domestically and overseas — leaves the gross margin at $8m. Take out general expenses, and the grower's net taxable income is now $3.75m domestically and $2m internationally. To determine the permanent federal tax savings using an IC-DISC, start by calculating its commission, which in this case can be either: 50% of export net income or 4% of export gross receipts (limited to export net income).

In this example, the first method gives us a commission of $1m (50% of $2m, the grower's net taxable international income), and the second gives us a commission of $600,000 (4% of $15m). Generally, the taxpayer will want to choose the larger of the two amounts for the greatest tax benefit. In this case, the first choice results in a $1m commission paid by the grower to the IC-DISC. As a result of this commission, the grower's taxable income is reduced by $1m. Because the grower is an S corporation, its shareholders report this income (now reduced by $1m) on their individual income tax returns. Assuming the shareholders are in the top tax bracket (and taxed at 37%), the commission payout results in a federal tax reduction of $370,000 in total for the shareholders. The $1m paid to the IC-DISC is taxed to the IC-DISC's owners (when paid or deemed paid) as a qualified dividend at the 23.8% rate (factoring in the 3.8% NIIT tax), resulting in tax of $238,000. The difference between the ordinary income tax saved by the individual shareholders and the qualified dividend tax liability incurred by the IC-DISC results in a tax savings of $132,000. The IC-DISC may also choose not to pay a dividend to its shareholders. In this case, an interest charge would apply to the deferred tax (hence the entity's name). The interest charges are based on Treasury bill rates, so at this time the potential interest charges are small. There are also deemed distribution rules related to qualified export receipts that exceed $10m; these rules can result in shareholders being taxed on the DISC's earnings without there being an actual distribution.

## Commissions

As summarized earlier, there are a few different methods that may be used to calculate (and optimize) the amount of commission the IC-DISC may receive.

- Four percent of its qualified export receipts, subject to export profit limitations
- Fifty percent of its CTI (its export profits)
- The actual amount earned by a buy-sell IC-DISC that has employees and operations of its own

## Annual maintenance of IC-DISC

Once an IC-DISC is formed, annual requirements must also be met. These requirements include:

- At least 95% of the gross receipts must be qualified export receipts.
- A reasonable estimate of the commission must be paid within 60 days of the exporter's tax year-end.
- An IC-DISC tax return, Form 1120-IC-DISC, must be filed annually by the 15th day of the ninth month following the close of the IC-DISC's taxable year. (The IC-DISC's taxable year must be the *same* as that of its principal shareholder.)
- The IC-DISC must maintain its own separate set of books and records.
- International boycott (Israel) operations must be disclosed (in conjunction with Form 5713).

At least 95% of the IC-DISC's assets must be qualified export assets that fall into several categories: export property, working capital (only the amount necessary for required working capital), commission receivable, stocks or securities of a related foreign export corporation, and producers' loans.

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Qualified export property must be

- manufactured, produced, grown, or extracted in the United States, and
- for use or consumption outside the United States.

Up to 50% of the fair market value of the export property can be attributable to foreign content.

Qualified export receipts include the following:

- The sale, exchange, or other disposition of export property
- The lease or rental of export property used outside the United States
- Related and subsidiary services
- Dividends from the related foreign export corporation
- Interest on obligations that are qualified export assets
- Engineering and architectural services for construction projects outside the United States

Sales made to U.S. distributors and sales made to foreign disregarded entities may qualify in some cases.

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