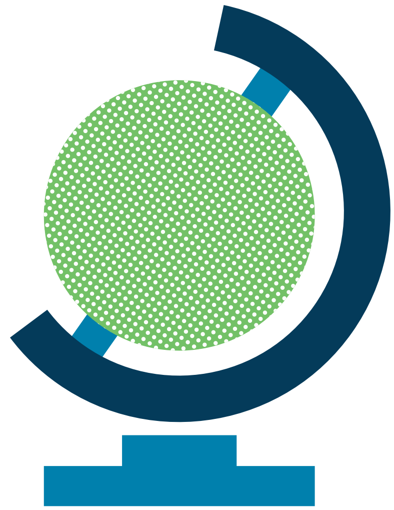

INTERNATIONAL TIDBIT:

New Spin on an Old DISC

For "old timers" in the international tax arena something called the Domestic International Sales Corporation or "DISC" has come and gone several times in tax planners' consciousness. It has roared back to life as the Interest Charge or IC DISC, this time as proposals to kill it off have been tabled. With the capital gains rate differential expected be around for a while, individuals can reap long-term tax benefits from this export incentive found in sections 991-998 of the Internal Revenue Code. The following is a general discussion of how it could work, including for companies with as little as $1 million a year in export sales.

DISC EARNS COMMISSION

The concept is a simple one – the DISC earns a commission for assisting with the sale of products made in the U.S. and destined for use outside the U.S. It earns that commission from a company ("ExportCo") making sales of U.S. products or performing certain services (see more about services, below). But it does not have employees, an office, or equipment to carry out its role. Rather, it elects to be treated as a DISC, enters into a commission agreement with ExportCo, keeps a set of books and records, and opens a bank account into which ExportCo pays the commission.

SELLER DEDUCTS COMMISSION

ExportCo receives a benefit by deducting a sales commission it would not have otherwise incurred with respect to qualified export receipts. If Export Co is an S corporation or a partnership (including an LLC treated as a partnership), the deduction flows through to the shareholders. There are several ways to determine the commission and these are provided in the statute. Generally, ExportCo can choose the most advantageous method and even determine it on a transaction-by-transaction basis.

SHAREHOLDERS RECEIVE DIVIDEND

The DISC offsets expenses against income but is not taxed on its earnings. When those earnings are paid out to individual shareholders, they are eligible to be taxed at capital gains rates as qualified dividend income. If the shareholders of the DISC are also shareholders of the S Corporation, they have effectively converted a portion of what would otherwise be ordinary income into capital gain.

EXPORT PROPERTY

The seller of export property is able to use the DISC as a commission agent on the sale. Export property is defined as property manufactured, produced, grown, or extracted in the U.S. and held primarily for sale, lease, or rental in the ordinary course of business for direct use, consumption, or disposition outside the U.S. Imported articles can make up part of export property but no more than 50% of the fair market value of the export property. Certain products are excluded, such as oil, gas, coal, and unprocessed softwoods. However, ExportCo does not have to be the manufacturer of the export property to use the DISC, just the seller earning qualified export receipts.

SERVICES FIRMS

Companies in the business of providing engineering or architectural services (“ServeCo”) with respect to construction projects located outside the U.S. are also eligible to use a DISC. The Treasury Regulations covering DISCs contain specific definitions and requirements for these types of services and the project involved. Nevertheless, using a DISC can be beneficial because of disadvantages ServeCo may face from a foreign tax credit perspective. As we have highlighted in prior Tidbits, income from services performed in the U.S. is considered U.S. source income even if the person benefiting from the services is resident outside the U.S. or the project is located there. In many cases, that foreign person is required to withhold foreign income tax from payments to ServeCo with the unfortunate result that U.S tax on ServeCo’s U.S. source income cannot be offset by withholding tax that can only offset U.S tax on foreign source income such as fees for services performed outside the U.S.

Using the DISC to earn income that is paid out as dividends taxed at capital gains to shareholders who also own ServeCo can help take some of the sting out of foreign taxes that may not have been anticipated and cannot be used to reduce U.S. tax on ServeCo’s income.

INTEREST CHARGE

The interest charge for the IC DISC refers to interest that shareholders are required to pay after tax has been deferred for one year. The interest is paid at the applicable federal rate assuming the income would be taxed to the shareholder as ordinary income.

CAP ON BENEFITS

For each year, a DISC may defer tax on up to $10 million of ExportCo’s or ServeCo’s qualified export receipts. To the extent this amount is exceeded, the DISC’s shareholders are treated as having received a dividend of the DISC’s current earnings and profits or other amounts as defined in the statute.

FOLLOWING THE RULES

Having a DISC involves following strict rules as to how it operates and how its commission and earnings are calculated. It exists for a specific statutory purpose and when used within those narrow confines can be beneficial, especially for shareholders who are individuals.

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