Inside Export Financing

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BKD CPAs & Advisors

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Domestic International Sales Corporations

BKD's IC-DISC services

- BKD's DISC practice has been serving clients with over fifteen years of dedicated DISC experience & a well developed process.
- Management Team of 3 partners, Managing Director, & Senior Manager with extensive IC-DISC experience
  - Team members present on DISC's at tax conferences & DISC workshops frequently
- Currently serving as tax advisor to 130+ DISC clients
- Utilize specialized software to perform transaction by transaction (TxT) analysis, transaction grouping & expense allocation to optimize tax benefits from a DISC
- Extensive experience with long term deferral strategies such as Producer's loans, factoring export receivables, & PEFCO paper.

Domestic International Sales Corporation

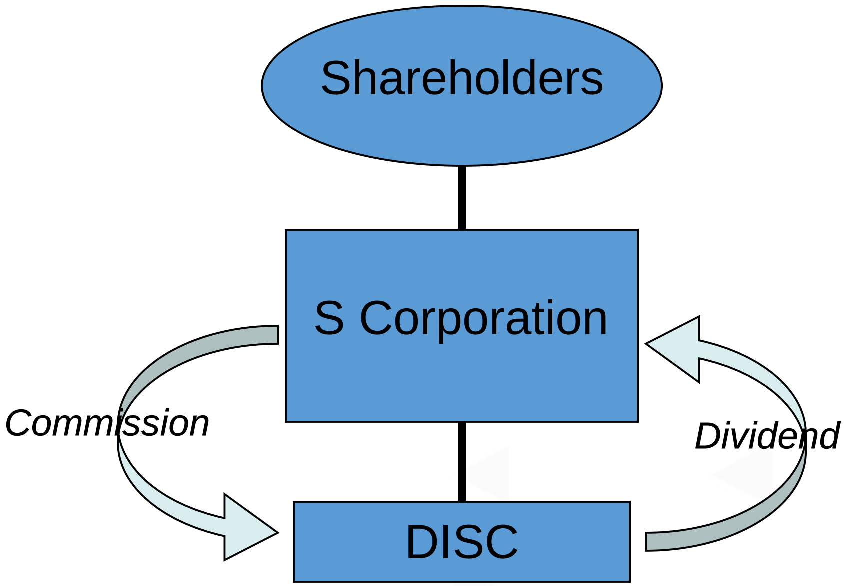
- DISCs can be a company with substance
  - Employees, customers, inventory, etc.
- But usually a DISC is just a “paper company” with no substance
  - No employees, no inventory, no direct relationship with customers
  - A U.S. taxpayer (the related supplier) is permitted to pay a commission to the DISC
  - Statutes describe the maximum amount of the commission
    - Generally speaking 4% of gross receipts or
    - 50% of the taxable income from the sale of export property

Domestic International Sales Corporation

- DISC benefit arises as follows:
  - Commissions paid to a DISC reduce taxable profit of related supplier
    - Generally speaking a 29.6% benefit for active owners of pass-through entities
    - May be additional state benefits
  - DISC is tax exempt entity
    - So it pays no federal income tax on the commission
  - DISC distributes its earnings to its shareholders
    - Shareholders are taxed on DISC earnings at lower qualified dividend rates
    - Domestic citizens & residents -- 20% + 3.8% = 23.8%

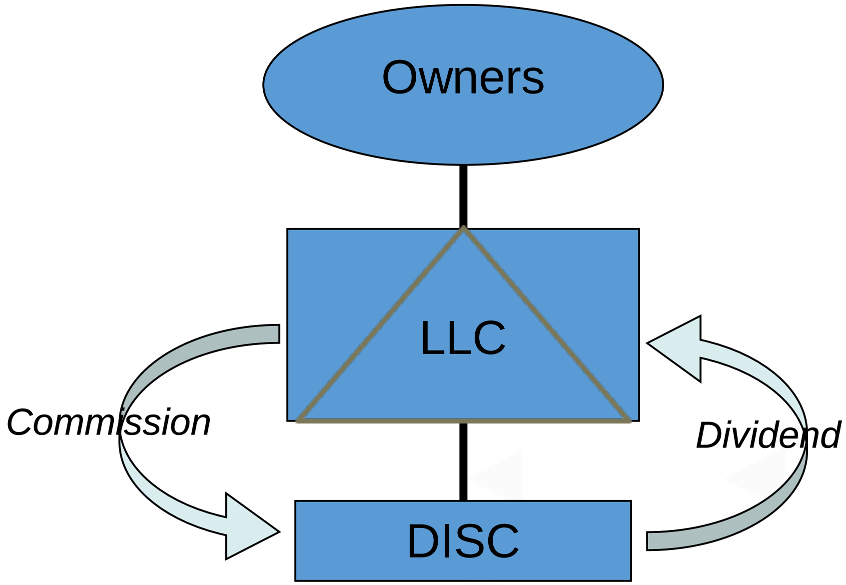
Possible DISC Structures

- Commission reduces taxable profit passed through to S corporation shareholder (29.6% tax savings)
- DISC is not subject to tax
- S corporation shareholders pay 23.8% tax on DISC dividends



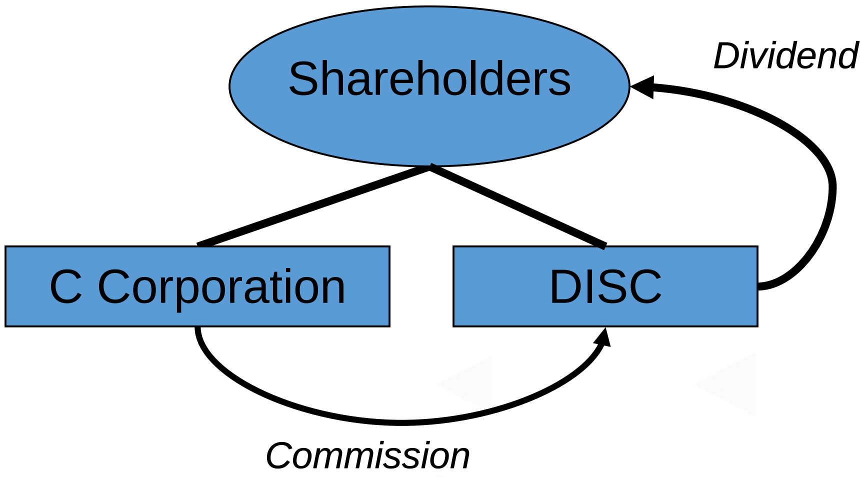
Possible DISC Structures

- Commission reduces taxable profit passed through to partners in the LLC
- DISC is not subject to tax
- Individual LLC owners pay 23.8% tax on DISC dividends



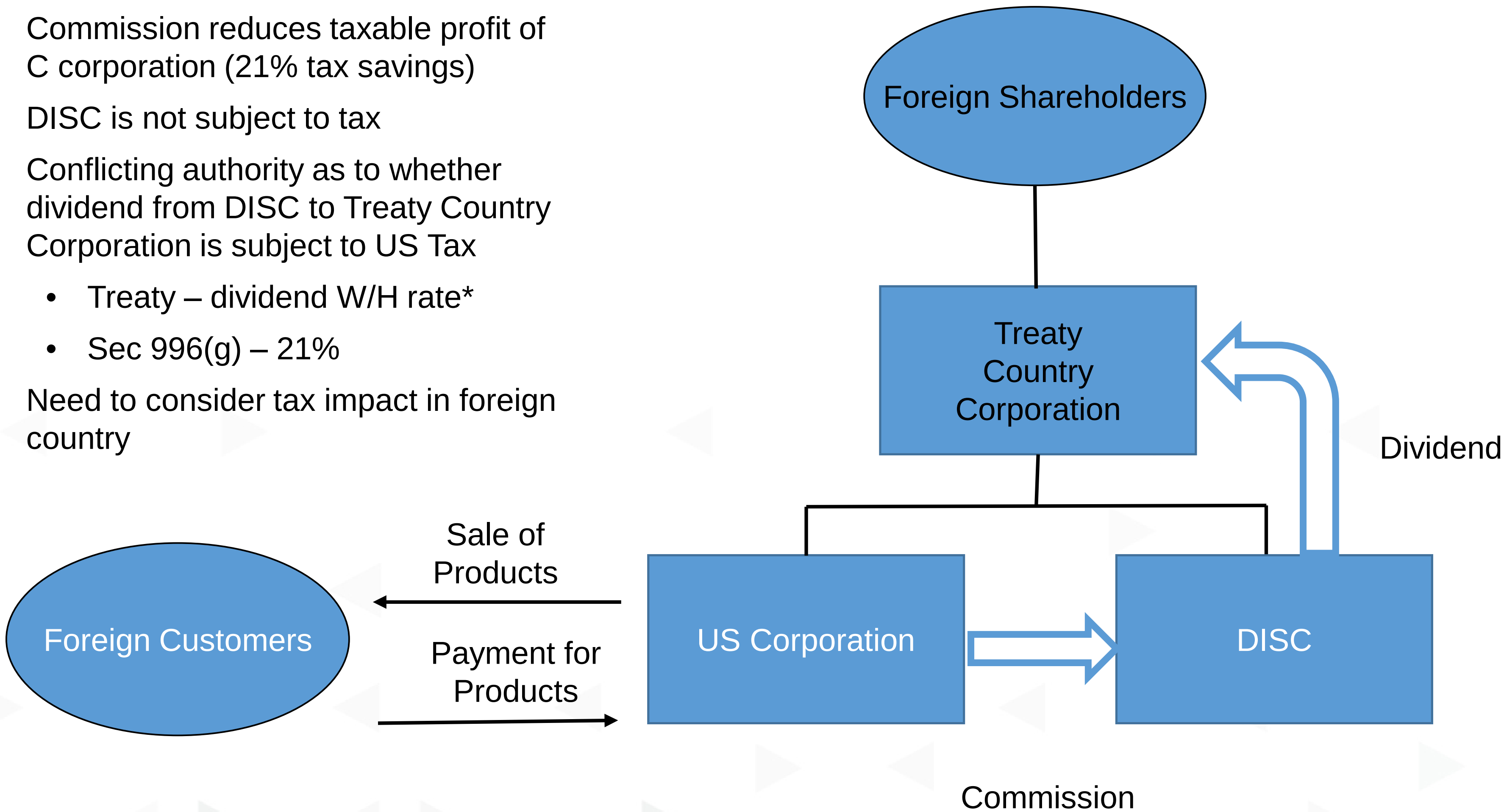
Possible DISC Structures

- Commission reduces taxable profit of C corporation (21% tax savings)
- DISC is not subject to tax
- Individual C corporation shareholders pay tax at 23.8% on DISC dividend



Possible DISC Structures

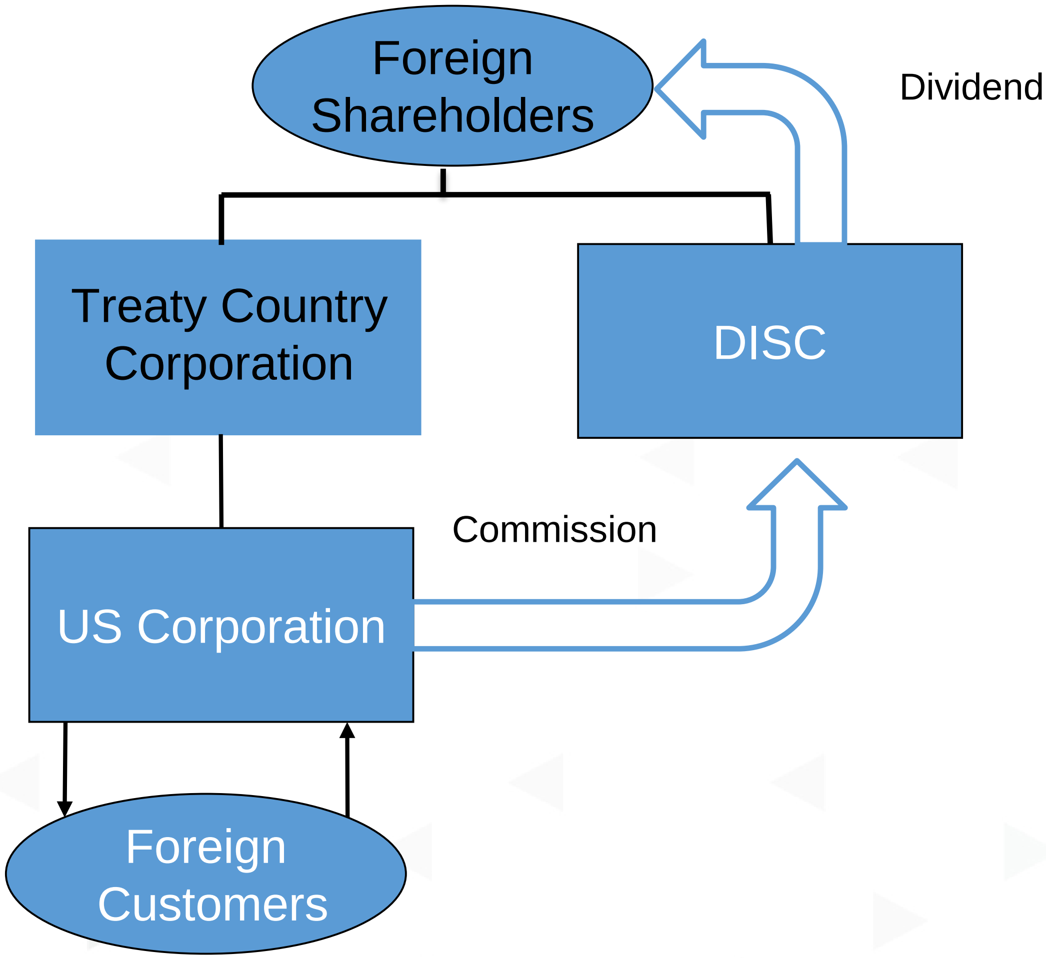
- Commission reduces taxable profit of C corporation (21% tax savings)
- DISC is not subject to tax
- Conflicting authority as to whether dividend from DISC to Treaty Country Corporation is subject to US Tax
  - Treaty – dividend W/H rate*
  - Sec 996(g) – 21%
- Need to consider tax impact in foreign country



* Some situations will result in withholding tax on DISC dividend.

Possible DISC Structures

- Commission reduces taxable profit of C corporation (21% tax savings)
- DISC is not subject to tax
- Conflicting authority as to whether dividend from DISC to Foreign shareholders is subject to full US
  - Treaty – dividend W/H rate
  - Sec 996(g) – 23.8%*
- Need to consider tax impact in foreign country



* Foreign owners still get capital gain rate if taxable under 996(g).

Domestic International Sales Corporation

- DISC profit equals greater of:
  - 50% of profits on sale of export property
  - 4% of qualified export receipts, not to exceed 100% of export profits
- The calculations are actually much more complicated
  - Transaction by transaction
  - Loss transactions
  - Marginal costing
  - Special 4% method

IC-DISC Benefits Example

Export Sales -- Widgets		1,000,000
Export Sales -- Gadgets		1,000,000
Total Export Sales		2,000,000
Cost of Sales -- Widgets		750,000
Cost of Sales -- Gadgets		750,000
Total Cost of Sales -- Exports		1,500,000
Gross margin -- Exports		500,000
Allocable Share of SG&A		300,000
Profit on Exports		200,000
DISC Commission		
50% Method		100,000
4% Gross receipts Method		80,000
(limited to 100% of profit)		
Higher of two methods		100,000

IC-DISC Benefits Example
Pass Thru structure

Tax Benefit of DISC Commission		**Example**		**Example**		
		Active Shareholders		Passive Shareholders		
DISC Commission reduces Operating Income		(100,000)		(100,000)		
Presumed Tax Rate on Operating Income		29.6%		33.4%		
		(29,600)		(33,400)		
Taxable Income from DISC Dividend		100,000		100,000		
Tax Rate on Disc Dividend Distributions		23.8%		23.8%		
		23,800		23,800		
Net (Benefit) from DISC		(5,800)		(9,600)		

IC-DISC Benefits Example
C Corp structure

Tax Benefit of DISC Commission						
		C Corp With DISC		C Corp Without DISC*		
Income		100,000		100,000		
Tax on Income		-		13,125		
Dividend		100,000		86,875		
Tax on Dividend		23,800		20,676		
Net Cash to Shareholder		76,200		66,200		10,000

*Note §250(a)(1)(A) foreign-derived intangible income deduction may reduce U.S. corporate tax rate on export sales by 37.5% (21% x 3.75% = 13.125%)

Domestic International Sales Corporation

- The estimated benefit can be much greater
  - The actual calculation is considerably more complex
  - Additional benefits available by implementing a factoring arrangement or a producer's loan

Requirements of a DISC

- Domestic corporation (C corporation)
  - Must be a domestic corporation incorporated under the laws of any state or the District of Columbia
  - Can not be
    - Tax exempt under section 501
    - A personal holding company
    - A financial institution
    - An insurance company
    - A regulated investment company
    - A China trade corporation
    - An S corporation

Requirements of a DISC

- Domestic corporation (C corporation)
- Must have separate bank account
- $2,500 capital requirement
- Single class of stock
- File timely elections (Form 4876-A within 90 days from beginning of tax year)
- 95% qualified export asset test
- 95% qualified gross receipts test

Requirements of a DISC

- DISC Compliance
  - DISC must file Form 1120-IC-DISC
    - Due 15th day of 9 month following tax year-end, no extension necessary
  - Must have the same tax year of the principal shareholder
  - Will report taxable dividends to shareholders on Schedule K
  - Possible state filing requirements
  - Interest charge on deferred DISC income reported on Form 8404

DISC - Categories of Gross Receipts

- Sale, exchange or other disposition of *export property*
- Lease or rental of *export property* used by the lessee outside the U.S.
- Services that are related & subsidiary to any qualified sale, exchange, lease, rental or disposition of export property
- Factoring income
- Interest income from producer’s loan

Export Property for DISC

- Manufactured, produced, grown or extracted in the U.S. by a person other than a DISC
- Held primarily for sale, lease or rental for direct use, consumption or disposition outside the U.S.
- Foreign content rule
  - Cost of foreign content used to manufacture product cannot be greater than 50% of FMV (sales price)

Domestic International Sales Corporation

- DISC statutes impose an interest charge on the undistributed portion of earnings in a DISC
- Owners are permitted a one year deferral before the interest charge applies
- U.S. T-bill rate used to calculate interest charge
  - Rate for deferrals at 12-31-2017 is 1.01%
  - On $1 million of deferred income, the interest charge for a corporation taxable at full rates would be $2,020

Domestic International Sales Corporation

- DISC statutes limit the amount of earnings that can stay in the DISC
  - Limited to profits on $10 million of qualifying gross receipts
  - Other amounts are deemed distributed on the last day of the year
  - Actual distributions then reduce “previously taxed” earnings & profits

Other U.S. Considerations:

- State income tax considerations
- DISC commissions paid to a DISC to the extent not related to foreign branch profits would generally reduce a US corp's foreign derived intangible income as a reduction to its foreign-derived deduction eligible income & its deemed intangible income

Foreign-Derived Intangible Income (FDII)

Foreign-Derived Intangible Income (FDII)

- New IRC Section 250(a)(1)(A)
- FDII applies only to U.S. C corporations
- Effective for taxable years beginning after December 31, 2017
- Expect a WTO challenge to FDII as U.S. trading partners may view it as an illegal export subsidy that violates U.S. international trade agreements

DEDUCTION FOR FOREIGN-DERIVED INTANGIBLE INCOME

- Section 250(a)(1)(A) provides for a deduction to a U.S. C corp equal to 37.5% of its foreign-derived intangible income (FDII)
  - Resulting in an effective 13.125% tax rate (21% corporate tax rate x 62.5%) on FDII for C corps
- For tax years beginning after December 31, 2025, the FDII deduction is reduced to 21.875%
  - Resulting in an effective 16.40625% tax rate on FDII

Foreign-Derived Deduction Eligible Income Constitutes Export Profits

- "Foreign-derived deduction eligible income" is profit from **property sold or leased / licensed** by a U.S. corp or **services** provided to a foreign person or with respect to foreign located property & is similar to "qualified export receipts" less allocable deductions under the DISC regime with the following differences:
  - Export product does not need to have been produced in the U.S. to qualify for FDII
  - Export product does not need to constitute at least 50% domestic content to qualify for FDII
  - Export services qualify under FDII without needing to be "related or subsidiary" to a sale of qualified export property

Foreign-Derived Deduction Eligible Income Constitutes Export Profits

- FDII is more restrictive than the DISC regime in a couple of respects:
  - Under the FDII rules, if a U.S. corp sells property to another person, other than a related party, for further manufacture or modification within the U.S., the property is generally not treated as sold for a foreign use even if such other person subsequently uses such property for foreign use
  - Foreign branch income, including income of a hybrid foreign entity such as a foreign disregarded entity or foreign partnership, is not eligible for FDII benefits even if it relates to the sale of export property

Related Party Transactions Can Qualify as FDII

- Income from property sold to a foreign related party qualifies for FDII provided that the foreign related party ultimately sells the property to an unrelated person for foreign use
- Income from services provided to a foreign related party qualifies for FDII provided that such service is not substantially similar to services provided by the foreign related party to persons located within the U.S.

Coordination of DISC & FDII Benefits

- There are no prohibitions against a U.S. C corp claiming both DISC & FDII benefits with respect to income from the sale of export property that qualifies under both regimes
- However, the deduction created by one regime would seem to reduce the deduction created by the other regime in a circular fashion:
  - The commission paid to a DISC to the extent not related to foreign branch profits would generally reduce a U.S. corp's FDII benefit as a reduction to its foreign-derived deduction eligible income & its deemed intangible income
  - The FDII deduction to the extent related to qualified export property under the DISC regime would generally reduce a U.S. corp's DISC commission through a reduction to qualified export profits
- Reminder, FDII only applies to C corps

FDII Deduction – Formula

$$\text{FDII Deduction} = 37.5\% \times \text{FDII (income)}$$

$$\text{FDII} = \frac{\text{Foreign Derived Eligible Income}}{\text{Total Income}} \times \left\{ \text{Net Income} - 10\% \text{ x Fixed Asset Basis} \right\}$$

The information contained in these slides is based on data available as of the date of the presentation & is not to be considered as tax advice. Applying specific information to your situation requires careful consideration of facts & circumstances. We are under no obligation to update these slides if changes occur. Consult your BKD advisor before acting on any matters covered.

Questions?

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Thank You!