Reducing Taxes for Manufacturers & Related Parties

Current & Future Savings Based On Export Sales

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Overview

This white paper describes the strategies the complexities of the tax code and strategies for manufacturers and related parties to reduce their current and future taxes.

Part 1
In "The Current Status of The Tax Code" we discuss the complexity of the tax code and the

Part 2
In "Tax Opportunities for Manufacturers and Related Parties that Export" we will discuss the IC-DISC and how it can be used to reduce current and future taxes.

- IC-DISC Background & History
- Qualifying for an IC-DISC
- Tax Savings With and Functionality of an IC-DISC
- Other Considerations

Part 3
Appendix

The Current Status of the Tax Code

The U.S. tax code is a complex and long. According to the Commerce Clearing House, as of 2013 it would take over 70,000 regular 8-1/2" x 11" sheets of paper to print. And just about every year or two it seems to get longer.

The most recent changes to the U.S. Tax Code took place going into the 2013 tax year with the passing of the American Taxpayer Relief Act of 2012 (ATRA). This Act permanently extended the Bush-era tax cuts for all but the highest income taxpayers from 35% to 39.6%. So now for high tier income taxpayers, out of the 260 days in a work year 103 days instead of 91 are ‘worked for the Federal Government’ and that does not even include State, sales, and property taxes.

When factoring in the different deductions, tax benefits and tax credits, the tax picture can look very different for certain individuals and corporations. And while manufacturers may be familiar with the Domestic Activities Production Deduction and the repealed Extraterritorial Income Exclusion, many companies and their CPAs are unaware of other tax saving strategies.

With proper and pro-active planning, taxes paid by qualified taxpayers in the manufacturing community, which also includes distributors, dealers and related parties that export, can be drastically reduced by applying the Interest Charge – Domestic International Sales

Tax Saving Opportunities for Manufacturers and Related Parties That Export

IC-DISC Background & History

The Interest Charged Domestic International Sales Corporation (IC-DISC) is one of the few remaining tax benefits to U.S. companies and taxpayers that export goods and/or certain services.

Prior to being called the IC-DISC, it was simply known as the Domestic International Sales Corporation (DISC) which was enacted by Congress in 1971. The intention of the DISC was to provide tax benefits to U.S. taxpayers that exported their products overseas. This benefit was created by allowing for income earned by the DISC to be deferred indefinitely until it was distributed to the DISC shareholders in the form of dividends.

Due to pressures from the international community, in 1984 the DISC was changed to the Interest Charge – Domestic International Sales Corporation. Adding the Interest Charge to the DISC made it so interest would have to be paid to the IRS on the deferred money within the IC-DISC. Additionally a cap was put in place so any money moved into or generated within the IC-DISC based on greater than $10,000,000 would be considered a deemed distribution and thus taxed as dividends whether actually distributed or not.

In 2003, with the passing of the Jobs and Growth Tax Relief Reconciliation Act of 2003 the dividend tax rate was reduced to 15%. This allowed the IC-DISC to distribute earnings to shareholders at the Qualified Dividend rate of 15% compared to ordinary income tax rates of 35%, creating another option for tax benefits via the IC-DISC.

The 15% dividend tax rate remained in place through 2012. With the passing of the American Taxpayer Relief Act of 2012 the dividend rate was changed for 2013 with a range of 15% to 20%, depending on income levels, plus an additional 3.8% Medicare add-on which also depended on income levels.

Even with the increase in the dividend tax rate, because of changes to ordinary tax rates a significant spread between the two still allow for significant tax savings.

Qualifying for an IC-DISC

Based on all the details of the U.S. Code, definitions, and rulings there are a few general areas that can be used to determine whether or not a taxpayer can qualify for and benefit from an IC-DISC. If the following questions can all be answered as "Yes" then tax savings can be achieved through an IC-DISC.

1. Is the operating company or sole proprietor profitable?
2. Is the operating company (or some/all of the shareholders of the company) or sole proprietor a U.S. taxpayer?
3. Does the operating company or sole proprietor have Qualified Export Receipts[1]?

While items 1 and 2 above are easy to discern, item 3 requires more explanation especially as it pertains to manufacturers and related parties.

In determining a Qualified Export Receipt ("QER") it is best to look at both what is and what is not a QER.

What is a Qualified Export Receipt?

A QER relates to the sale of "Export Property" to locations outside of the United States and is defined as

1. Property that is manufactured, produced, grown, or extracted in the United States. Essentially this includes any product made in the United States, or predominantly (see

[1] Treas. Reg. § 993(c)(1)

below) made in the United States. For further explanation, each of the following are defined:

- Manufactured- Relates to the "substantial transformation" of physical items or conversion of items (other than packaging, repackaging, labeling and minor assembly)
- Produced – Relates to video, audio, art, and software products as well as architecture and engineering services
- Grown - Relates to agriculture items such as crops, commodities, and livestock
- Extracted – Relates to certain natural resources

2. Is held primarily for sale, lease, or rental, in the ordinary course of trade or business for direct use, consumption, or disposition outside the United States.

    Simply put the item being exported must go to a place outside of the United States, other than Puerto Rico, Guam and other U.S. Territories or countries in which there are trade embargos. It does not matter whether the item is sold directly to the end user or if it is sold through third parties, resellers, or distributors.[2]

    There are other stipulations under this rule which include:

    - The item must be shipped outside of the United States within one year of purchase.

    - If the item that is exported is to return to the U.S. within three years of being exported it would not meet export requirements.

3. Not more than 50 percent of the fair market value of which is attributable to articles imported into the United States.

    Known as the "Foreign Content Test" or the "50% Test" it must be proven that what is being exported has at least half of its content derived in the United States. In simple terms if an item is imported into the United States and then exported back out, if the selling price is at least twice the cost the Foreign Content Test is satisfied. And while the actual manufacturing or production may clearly take place in the United States, if one or more of the component or materials used in the development or manufacturing process is imported into the United States it must pass the Foreign Content Test.

[2] Treas. Reg. § 1.993-3(d)(2)

What is not a Qualified Export Receipt?

Besides the location of the ultimate use of the item being exported, items that are excluded from Export Property include but is not limited to[3]:

- patents, inventions, models, designs, formulas, or processes, whether or not patented, copyrights (other than films, tapes, records, or similar reproductions, for commercial or home use), goodwill, trademarks, trade brands, franchises, or other like property,
- products of a character with respect to which a deduction for depletion is allowable (including oil, gas, coal, or uranium products),
- products the export of which is prohibited or curtailed, or
- any unprocessed timber which is a softwood.

In addition to the above, services other than Architectural and Engineering services would not be considered QER. For example, banking, finance, legal, medical and other services would not be QER.

[3] Treas. Reg. § 993(c)(2)

Manufacturers and Related Parties More Detailed

In general terms, the IRS Code and Regulations define manufacturing as any of the following:

1. "Substantial transformation" of purchased property prior to sale:
    a. Examples of substantial transformation include the conversion of wood pulp to paper, steel rods to nuts, bolts and screws and the canning of fish.

2. Performs activities that are substantial in nature and generally considered to constitute manufacture or production, or construction of property, or

3. Incurs Conversion costs (direct labor and factory burden) that account for 20% or more of the total cost of goods sold or the adjusted basis for such property, to where the conversion costs included assembly and packaging costs (but not parts under a service contact).

As long as the above criteria are met, along with the other items in "Qualifying for an IC-DISC " it does not matter whether the item is sold directly or through third parties such as distributors or third parties, the item is considered an export. And in the cases where there are third party sellers or distributors, as long as they take title to the manufactured item, they too can consider themselves of having Qualified Export Receipts even though they themselves did not create the item being exported.

Additionally, there may be instances where the item being manufactured is a component to a larger Qualified Export. In those cases the component manufacturer may also qualify for tax savings through an IC-DISC.

Therefore, based on the above -and assuming the individuals involved, whether corporations, shareholders of corporation, or sole proprietors are U.S. taxpayers and are profitable or are paying taxes – an IC-DISC can be used to reduce taxes.

Tax Savings With and Functionality of an IC-DISC

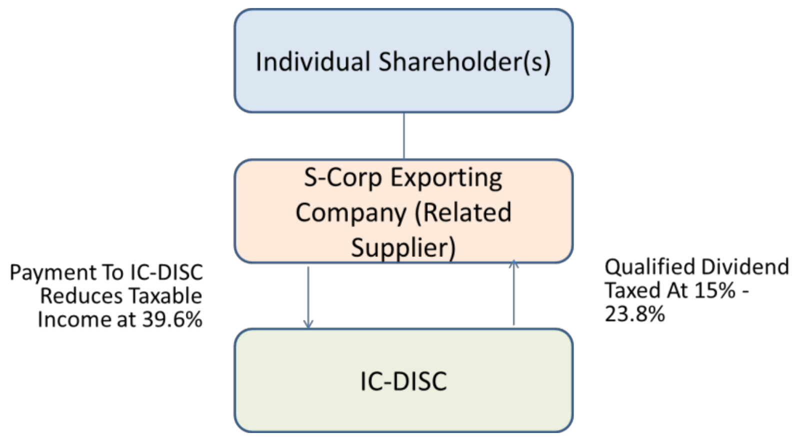
Tax savings are achieved through an IC-DISC by converting Ordinary Income into Qualified Dividend Income.

Under the IC-DISC tax savings set up there is an Operating Company and an IC-DISC. The Operating Company is the already established functioning company or sole proprietorship where all production, manufacturing, sales, marketing, exporting and other everyday business activities take place. The IC-DISC on the other hand functions as a shell corporation with no operations, employees, or facilities.

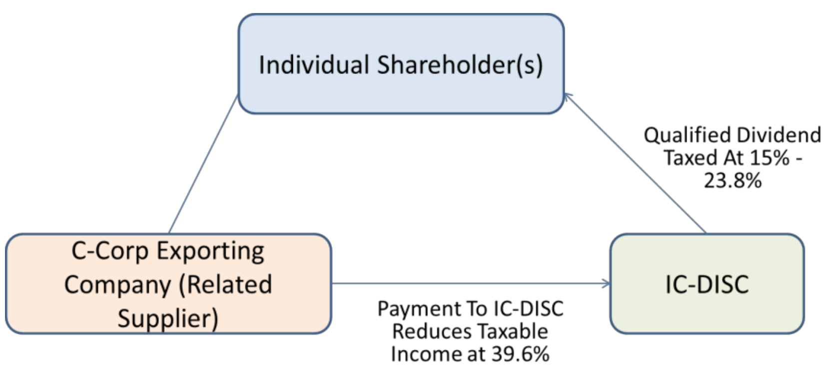
Based on the revenues generated from the Qualified Export Receipts and/or the pre-tax profitability of those Qualified Export Receipts by the Operating Company, a fee can be paid to the IC-DISC. This fee is treated as an expense to the Operating Company and thus reduces taxable income in the corporation (or to its shareholders in the case of a flow-through entity) which can be taxed as high as 39.6%.

In turn, the IC-DISC picks up this money as income which is not taxed at the corporate level. Rather, the IC-DISC distributes the income to its shareholders in the form of Qualified Dividends which are taxed between 15% and 23.8%. Therefore, the spread between the money that would have been taxed at the corporate level or as Ordinary Income at 39.6% is now being taxed as Qualified Dividends at 15% to 23.8% creates what could be significant tax savings. This is illustrated in the following:

Operating Company is an S-Corp or other Flow-Through entity, so the operating company can own the IC-DISC and thus the payments to the IC-DISC return to the operating company and flow-through to the shareholders as Qualified Dividends:



Operating Company is a C-Corp in which case the individual shareholders are the owners of the IC-DISC and thus the payments to the IC-DISC are paid out directly to the shareholders of the IC-DISC. (This can also be the set-up for flow-through entities if the shareholders of such entity choose to do so.)



As an example, the tax rate paid by a manufacturer generating $7,000,000 in taxable income, half of which is export related:

Taxpayer – 100% Owner of Corporation		
	Without IC-DISC	With IC-DISC
Operating Company Ordinary Income	$7,000,000	$5,250,000
Operating Company Related Taxes	$2,772,000	$2,079,000
Operating Company Related Income After Taxes	$4,228,000	$3,171,000
Payment To IC-DISC		$1,750,000
Taxes Related To IC-DISC		$ 416,500
Income After Taxes IC-DISC		$1,333,500
Combined Total Income After Taxes	$4,228,000	$4,504,500
Combined Total Taxes	$2,772,000	$2,495,500
Tax Savings With IC-DISC		**$ 276,500**

Other Considerations

The IC-DISC is the only way to obtain export related tax benefits in the United States. While this white paper allows a taxpayer to determine whether they may qualify for an IC-DISC and general information about the structure and savings that can be obtained with one there are other things to consider:

1. The IC-DISC is a separate entity therefore savings are not retroactive so tax savings diminish the longer a taxpayer waits to establish one.

2. An IC-DISC requires specific filings with the IRS and agreements between it and the related operating company.

3. Additional tax compliance rules that need to be adhered to with an IC-DISC not detailed in this document, and while not overly complex they must be observed.

4. There are different methods to calculate the amount of money that can be used to determine the amount of money that can be moved through an IC-DISC. Within those methods there are methods allowed under the IRS Code that can further increase those benefits.

5. There are certain timing and ownership issues related to the IC-DISC that can help in tax and estate planning.

Appendix

U.S. Tax Code for IC-DISC

The U.S. Tax Code pertaining to IC-DISCs are encompassed in the following code sections:

- § 991 - Taxation of a Domestic International Sales Corporation
- § 992 - Requirements of a Domestic International Sales Corporation
- § 993 - Definitions
- § 994 - Inter-Company Pricing Rules
- § 995 - Taxation of DISC Income to Shareholders
- § 996 - Rules for Allocation in the Case of Distributions and Losses

In addition to the U.S. Tax Code the IC-DISC rules are shaped by various rules and definitions within the Code and Legal Rulings from court cases pertaining to IC-DISCs.

2014 Tax Rate Schedules

Corporate Tax Rates – C Corporations			
Pre-Tax Income Over	Pre-Tax Income Not Over	The Tax Is	Of the Amount Over
$0	$50,000	$0 + 15%	$0
$50,000	$75,000	$7,500 + 25%	$50,000
$75,000	$100,000	$13,750 + 34%	$75,000
$100,000	$3350,00	$22,250 + 39%	$100,000
$335,000	$10,000,000	$113,900 + 34%	$335,000
$10,000,000	$15,000,000	$3,400,000 + 35%	$10,000,000
$15,000,000	$18,333,333	$5,150,000 + 38%	$15,000,000
$18,333,333	$-	35%	$0

Since S Corporations and other Flow-Through entities are not taxed at the corporate level, the tax rates for individuals are as follows:

Married/Filing Jointly			
Pre-Tax Income Over	Pre-Tax Income Not Over	The Tax Is	Of the Amount Over
$0	$17,850	$0 + 10%	$0
$17,850	$72,500	$1,785 + 15%	$17,850
$72,500	$146,400	$9,983 + 25%	$72,500
$146,400	$223,050	$28,458 + 28%	$146,400
$223,050	$398,350	$49,920 + 33%	$223,050
$398,350	$450,000	$107,769 + 35%	$398,350
$450,000	$-	$125,846 + 39.6%	$450,000

Single			
Pre-Tax Income Over	Pre-Tax Income Not Over	The Tax Is	Of the Amount Over
$0	$8,925	$0 + 10%	$0
$8,925	$36,250	$883 + 15%	$8,925

$36,250	$87,850	$4,991 + 25%	$36,250
$87,850	$183,250	$17,891 + 28%	$87,850
$183,250	$398,350	$44,603 + 33%	$183,250
$398,350	$400,000	$115,566 + 35%	$398,350
$400,000	$-	$116,164 + 39.6%	$400,000

The above does not include certain items depending on how taxpayers are structured such as:

- Self-employment taxes of 16.2%[4] (12.4% social security, 2.9% for Medicare) for wages up to $117,000.

- Additional Self-employment tax of .9% Medicare add-on for certain threshold amounts of $200,000 for individuals and $250,000 for married tax payers.

2014 Qualified Dividend Tax Schedule

All Individual Taxpayers	
Ordinary Income Tax Bracket	Dividend Tax Rate
10% and 15%	0%
25%, 28%, 33%, 35%	15%
39.6%	20%

Additional 3.8% federal Medicare tax applies to individuals with Adjusted Gross Income of $200,000 (filing single) or $250,000 (married filing jointly).

[4] Half of this amount is paid for by the employer; however, often with small businesses and sole proprietors they are self-employed or 100% owner of their company so they are paying the full amount.