

U.S. Tax Benefits for Exporting

By

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- Masters in Tax Law from New York University Law School
- Four years of U.S. Tax Court and Internal Revenue Service experience in Washington D.C.
- The firm regularly works with law firms, accountants, businesses and individuals struggling to find their way through the complexities of the tax law.
- In short, the firm is a valuable resource to each of these audiences.
- With over 38 years as a tax lawyer in Florida, Lehman has built a tax law firm with a national reputation for being able to handle the toughest tax cases, structure the most sophisticated income tax and estate tax plans, and defend clients before the IRS.

A dark wood desk with a blue pen and a glass of water. The text is centered on the desk.

IC-DISC

A Major Tax Saving Tool

IC-DISC

A Major Tax Saving Tool

- 1) Tax incentive for Americans who export product.
- 2) Available to manufactures, producers, wholesaler and retailer that sell “export property”



IC-DISC

A Major Tax Saving Tool

The U.S. Taxpayer pays
15% Tax Rate on export profits.

Instead of a **35% Federal Tax Rate**.

IC-DISC

A Major Tax Saving Tool

If you live in a State that has City/State
Income Tax - **You pay 15% tax rate**
NOT 50% on your export profits.

Plus

Taxpayer can defer export profits for many
years at low interest costs.

Major Tax Reductions for Export Profits

U.S. taxpayers that sell, lease or license “export property” which is manufactured, produced or grown in the United States (not more than 50% of which attributable to U.S. imports), **can take advantage of strong support for their export profits in the Internal Revenue Code.**

The United States Tax Benefits of Exporting

- In 2012 the business world is going to be a tough place for the American Exporter.
- Take advantage of the Internal Revenue Code and it's strong support for export profits.

Major Tax Reductions for Export Profits

1. Establish a new corporation dedicated almost exclusively to export profits;
2. a separate set of export books and records; and
3. abiding by a relatively simple set of rules that govern Domestic International Sales Corporations (now known as “IC-DISC”).

How does it work.

- Typically the U.S. taxpayer that establishes the IC-DISC will be related to the IC-DISC and even own the IC-DISC. The U.S. taxpayer agrees to pay the IC-DISC based on a Commission Agreement.
- A portion of the U.S. taxpayer's "export profits" are paid to the IC-DISC and the payment is deducted from the profits of the U.S. manufacturer, seller or licensor.
- The portion of the U.S. taxpayer's "export profits" that are paid to the IC DISC are measured under three profit scenarios. The deduction may exceed more than 50% of the U.S. Taxpayers' export profits, depending upon gross income, profitability and costs.

IC-DISC Rules

The IC-DISC must sell, lease, license or service “export property”

- **Export property means property:**

Manufactured, produced, grown or extracted in the United States; held for sale, lease or rental, in the ordinary course of business, for use, consumption or disposition outside the United States; and Not more than 50% of the fair market value of which is attributed to articles imported into the United States.

IC-DISC Requirements

1. A corporation taxable as a corporation, must be formed under the laws of any State or the District of Columbia to be the IC-DISC
2. The corporation must have only one class of stock and minimum capital of \$2,500. The IC-DISC shareholders may be related to the IC-DISC.
3. The IC-DISC must take a tax election to be an IC-DISC that must be filed with the Internal Revenue Service within 90 days after the beginning of the tax year of the IC-DISC.
4. The IC-DISC must maintain separate books and records.
5. The IC-DISC must have at least 95% or more of its gross receipts considered to be Qualified Receipts resulting from the DISC's export activities.
6. The IC-DISC must have at least 95% or more of its assets considered to be Qualified Export Assets.

The DISC Owner

Typically the IC-DISC is established, by a related company that is engaged in a United States business that includes gross revenues from both domestic and international sources. The related company's principals will be the direct or indirect owners of the IC-DISC

The DISC Owner

U.S. Individual

U.S. Individual

Owns
U.S. Export
Manufacturer

Pays
Commission

Owns
I.C. DISC
Corp.

Sales
To

Earns

Non U.S.
Customers

Tax Free
\$ Commission

The Tax Benefits

Thus the magic of the IC-DISC is to provide both tax deferral and to apply a 15% maximum dividend tax rate to profits that would otherwise be taxable in the U.S. taxpayer's highest brackets that can range as high as 50%.

Tax Deferral

There is a cost to take advantage of the tax deferral tax benefit available using an IC-DISC. However, in today's climate and for the foreseeable future, the cost is minimal.

The IC-DISC rules provide that an "interest charge" must be calculated on IC-DISC distributions that are not paid as taxable dividends in the year earned.

“50-50”		4%	
Export gross receipts	\$4.0 Million	Export gross receipts	\$4.0 Million
Cost of Goods Sold	2.0 Million	Cost of Goods Sold	2.84 Million
Gross Profits	2.0 Million	Gross Profits	1.16 Million
Selling, general and administrative costs	1.0 Million	Selling, general and administrative costs	1.0 Million
Export sales net income	1.0 Million	Export sales net income	160,000
IC-DISC commission 50% of export net income	500,000	IC-DISC commission 4% of export gross receipts	160,000
Manufacturer Taxable Income	500,000	Manufacturer Taxable Income	- 0 -
Federal tax cost (35%) Export Net Income	- \$175,000	Federal tax cost (35%) Export Net Income	- \$ 56,000
Federal tax cost (15%) IC-DISC Dividend Income	- \$ 75,000	Federal tax cost (15%) IC-DISC Dividend Income	- \$ 24,000
IC-DISC net tax savings 20% of Net Income	= \$100,000	IC-DISC net tax savings	= \$ 32,000

Major Savings

IC-DISC shareholders still will receive the 15% tax rate on the DISC dividends in excess of \$10 Million.

The Commission Payments

- **Gross Receipts Method**

- **Taxable Income Method**

“Export promotion expenses” means those expenses incurred to advance the distribution or sale of export property for use, consumption, or distributions outside of the United States but does not include income taxes.

- **Arm’s Length Method**

The transfer price for a sale by the related supplier to the DISC is to be determined on the basis of the sale price actually charged but subject to the rules provided by the rules of sales between related parties.

IC-DISC

The Export Disc Corporation

Computer Software,
Internet Sales & Licenses

IC-DISC

A Major Tax Saving Tool

The IC-DISC has been approved as an acceptable tax planning entity for the export of American produced computer software and programs as early as 1985.

Computer Programs Are Usually Sold Pursuant to "License" or "User Agreements".

- A computer program transaction is unlike a sale of a physical object since the value of the program copy far exceeds the value of the physical medium on which it is transferred.
 - Often, there is no physical medium at all.

For purposes of determining the applicability of the DISC to computer software exports, two key analyses are often required.

- (1) is the software “export property” for DISC purposes and
- (2) is the software product’s source of income “from without the U.S.”? Is the product for use, consumption or sale without the U.S.?

I.R.S. Guidance

- In 1985, the I.R.S. issued guidance that indeed certain computer software programs constituted “export property” for DISC purposes.
- In doing so the Technical Advice not only reviewed the legislative history of the DISC rules it also pointed out the distinctively different treatment that “patents, inventions, models, decisions, formulas, or processes whether or not patented, copyrights, goodwill, trademarks, trade brands, franchise or other like property” receive under the DISC rules, as opposed to the treatment of “films, tapes, records or similar reproductions, for commercial or home use.”

Copyright law is the basis for the Software Regulations

- The Regulations are based on the concept that it is possible to categorize a computer program transaction by analyzing the copyright rights transferred.
- The most important distinction created by the Software Regulations is the distinction between copyrighted articles and copyright rights.
- **The Copyright Rights are not “export property” for DISC purposes while the Copyright Articles are “export property”.**

Export Property Analysis

Export property is defined to mean, in general, property that is:

- A. Manufactured, produced, grown or extracted in the United States by a person other than a DISC,
- B. Held primarily for sale, lease, or rental, in the ordinary course of trade or business, by, or to, a DISC, for direct use, consumption, or disposition outside the United States and
- C. Not more than 50 percent of the fair market value of which is attributable to articles imported into the United States.

Export Property Does Not Include

“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), good will, trademarks, trade brands, franchises, or other like property”

Computer software can be export property.

- Computer software tapes are akin to the copyrighted books, which qualify as export property.
- Computer programs are standardized programs that are manufactured in the United States by a person other than a DISC and then marketed outside the United States.
 - This is not selling the source code or master recording.
- Those purchasing or leasing programs do not have the right to reproduce the software.

Copyright Rights

The transfer is classified as a transfer of a copyright if, as a result of a transaction, a person acquires any one or more of the following rights:

1. the right to make copies of the computer program for purposes of distribution to the public by sale or other transfer of ownership, or by rental, lease or lending;
2. the right to prepare derivative computer programs based on the copyrighted computer program;
3. the right to make a public performance of the computer program; or
4. the right to publicly display the computer program.

Transfers of Computer Programs

A computer program includes any media, user manuals, documentation, database or similar item if the media user manuals, documentation, database or similar item is incidental to the operation of the computer program.

Transfers of Computer Programs

A copyrighted article is defined as a copy of a computer program from which the work can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device.

If a person acquires a copy of a computer program but does not acquire any of the four copyright rights, the transfer is classified as a transfer of a copyrighted article.

A transfer of a computer program is classified in one of the following ways.

1. A sale or exchange of the legal rights constituting a copyright (which generates income sourced according to the rules for sales of personal property);
2. A license of a copyright (which generates royalty income);
3. A sale or exchange of a copyright article produced under a copyright (which generates income sourced according to the rules for sales of personal property);
4. A lease of a copyright article produced under a copyright (which generates rental income).¹
 1. Additional rules allow for the classification of a transfer as partially a transfer of services or of know-how. The provision of know-how, in which the transferor retains continuing use of the know how transferred, is presumably most like a license of a copyright.

The Source of Income Analysis

Once it is determined that a computer program is a copyright article and thus “export property” for DISC purposes;

. . . then the issue is to determine whether the Software Program is being sold for use, consumption or disposition outside of the U.S. This analysis depends upon the “source of income” rules.

Income from Sales of Property

- Generally under the current rules, the source of income from sales of property depends to varying extents upon both the type of property and whether the property sold or leased is “inventory property”.
- Income from the lease of a copyright article must also fit this definition of non U.S. source of income.
- Determination of whether the transaction is a sale of inventory, a rental of property, a license or sale of intellectual property or the provision of services.

Income from Sales of Property

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Income from Sales of Property

The regulations focus on

- (i) acknowledging the special circumstances of computer programs,
- (ii) distinguishing between transactions in copyright rights and in copyrighted articles, and
- (iii) focusing on the economic substance of the transaction over the labels applied, the form and the delivery mechanism.

Source of Income for Sales of Copyrighted Articles

The source of income generated by the sale or exchange of a copyrighted article often depends upon whether the sale took place within or without the United States. **The Software Regulations provide that the place of sale is determined under the “title passage rule”.**

Title Passage Rule

There are important categories of copyrighted article transfers for DISC purposes:

- (i) a transfer of tangible property, such as a tangible medium in which the copyrighted article is embodied, and/or a hard copy of user manuals and documentation;
- (ii) (e.g., electronically transmitted copyrighted articles without any hard copy of user manuals and documentation).

Either one of these can be the subject of a sale.

Lease and Rental Source of Income

- If less than all of the benefits and burdens associated with a copyrighted article have passed to the transferee, the Software Regulations treat the transaction as a lease.
- As a general rule, rents and royalties are sourced to the place where the leased or licensed property is located, or where the lessee or licensee uses, or is entitled to use the property.

Sale of Copyright Article

Example 1

- A U.S. corporation, (the “U.S. corporation”) owns the copyright in a computer program, (the “Program”).
- The U.S. corporation, (the “U.S. Corporation”), makes the Program available, for a fee, on a World Wide Web home page on the Internet. Mr. P, a resident of Country Z, in return for payment to the U.S. Corporation, downloads the Program X (via modem) onto the hard drive of his computer. As part of the electronic communications, P signifies his assent to a license agreement.
- Mr. P receives the right to use the program on his own computers (for example, a laptop and a desktop). None of the copyright rights have been transferred in this transaction. P has received a copy of the Program. P has acquired solely a copyrighted article.
- P is properly treated as the owner of a copyrighted article. There has been a sale of a copyrighted article rather than the grant of a lease.

Lease of Copyright Article

Example 2

- The facts are the same as those in Example 1, except that the U.S. Corporation only allows Mr. P, the right to use the Program for one week. If P wishes to use the Program for a further period he must enter into a new agreement to use the program for an additional charge.
- P is not properly treated as the owner of a copyrighted article. There has been a lease of a copyrighted article rather than a sale.

Sale of Copyright

Example 3

- A U.S. Corporation, transfers a disk containing the Program to a Foreign Corporation (the “Foreign Corporation”) and grants the Foreign Corporation an exclusive license for the remaining term of the copyright to copy and distribute an unlimited number of copies of the Program in the geographic area of the Country in which the Foreign Corporation makes public performances of the Program and publicly displays the Program.
- Applying the all substantial rights test, the U.S. Corporation will be treated as having sold copyright rights to the Foreign Corporation. The Foreign Corporation has acquired all of the copyright rights in the Program and has received the right to use them exclusively within the Foreign Country.

Lease of Copyright Rights

Example 4

- A U.S. corporation, transfers a disk containing the Program to a Foreign Corporation in Country X and grants the Foreign Corporation the non exclusive right to reproduce (either directly or by contracting with another person to do so) and distribute for sale to the public an unlimited number of disks at its factory in return for a payment related to the number of disks copied and sold. The term of the agreement is two years, which is less than the remaining life of the copyright.
- There is a lease of copyright rights since copyright right have been assigned but for a limited time period only.



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