

# **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 "IC-DISC" is written in large white letters in the center of the image.

# IC-DISC

A Major Tax Saving Tool

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## A Major Tax Saving Tool

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- 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

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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

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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.



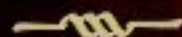
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**Value can be lost without good  
professional advice.**

# IC-DISC

Interest Charged –  
Domestic International Sales  
Corporations



The background of the slide is a dark, textured wooden surface. In the top right corner, there is a glass of water. In the bottom left corner, there is a blue pen with gold-colored accents.

# **The IC-DISC is a separate corporation.**

The income received by the DISC is  
not taxable to the DISC.

# 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.**



# 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).

# 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.



# 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%.

A dark wood desk with a blue pen and a glass object.

The DISC is charged with accounting separately for a U.S. “taxpayer’s export profits” and receives more than 50% of the export profits free of any U.S. taxation.



# The DISC Owner

U.S. Individual

U.S. Individual

**Owns**  
U.S. Export  
Manufacturer



**Pays**  
Commission



**Owns**  
I.C. DISC  
Corp.

**Sales**  
**To**



Non U.S.  
Customers

**Earns**



**Tax Free**  
**\$ Commission**

# 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

Interest Charged –  
Domestic International Sales  
Corporations

# 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.



# 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.

# Tax Deferral

Shareholders still will receive the  
15% tax rate on the  
DISC dividends in excess  
of \$10 million.



## **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

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

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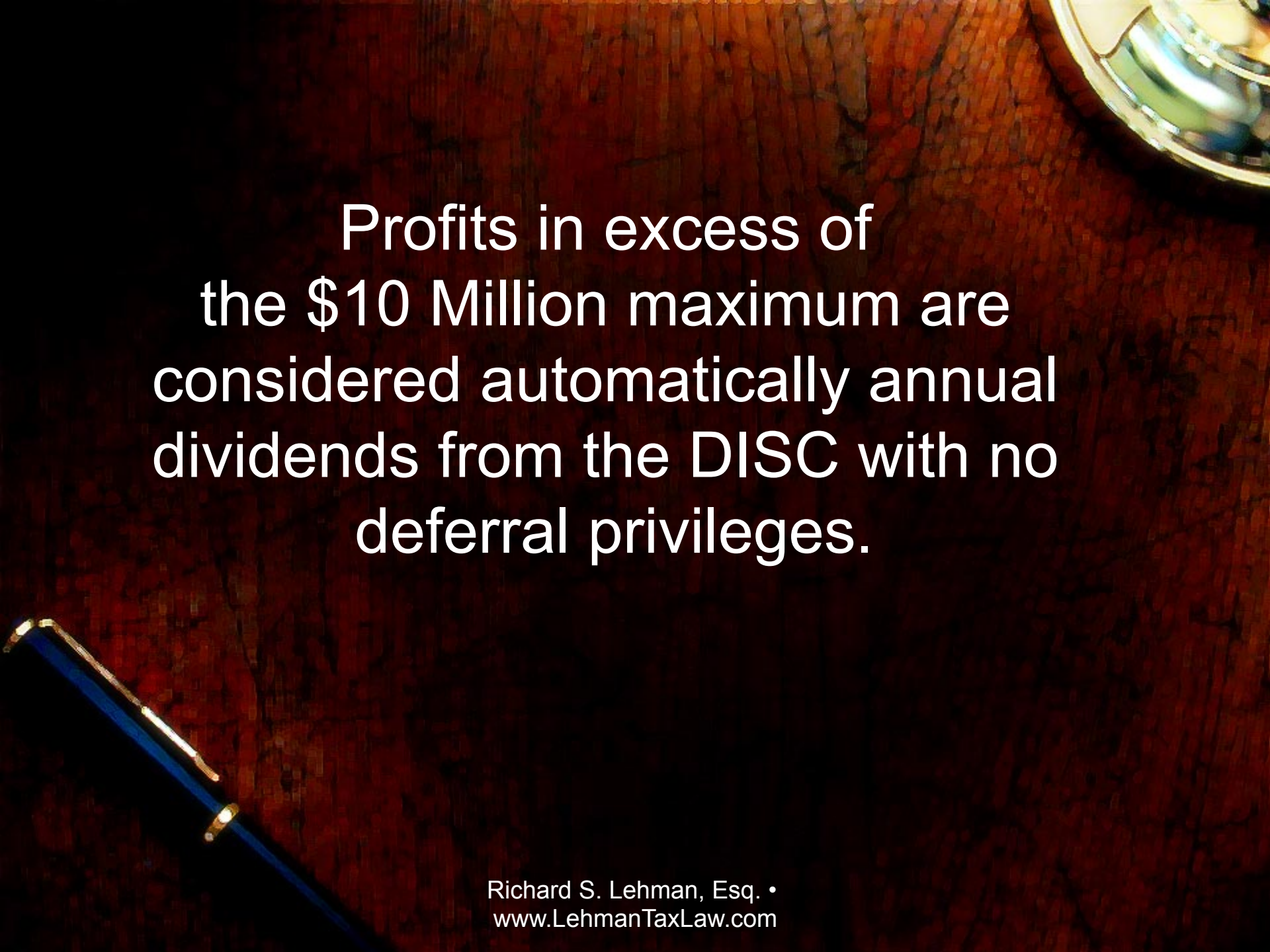
**Sales  
To**

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Non U.S.  
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Tax Free  
\$ Commission



A dark wood desk with a blue pen and a glass object.

Profits in excess of  
the \$10 Million maximum are  
considered automatically annual  
dividends from the DISC with no  
deferral privileges.



## **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.



<b>“50-50”</b>		<b>4%</b>	
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
<b>Manufacturer Taxable Income</b>	<b>500,000</b>	<b>Manufacturer Taxable Income</b>	<b>- 0 -</b>
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



# IC-DISC

## The Export Disc Corporation

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Computer Software,  
Internet Sales & Licenses



# IC-DISC

## A Major Tax Saving Tool

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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.

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By establishing an I.C. DISC  
you can reduce your taxes, in  
some cases, from 50% to 15%  
on your export profits from  
computer software.



# 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.”

# 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 . . . ”



# 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.

# 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 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”.

A dark wood desk with a blue pen and a glass object.

More than 50% of the computer  
software was produced in the  
United States.



# 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.

# 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”.**



# 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).<sup>1</sup>
  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.

# 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.



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Copyright Rights are not  
“export property”

Copyright Articles are  
“export property”

# Export Property Analysis

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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.

# 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.



# The Difference Between

Sale of a copyright article  
Lease of a copyright article

Sale of a copyright  
Lease of a copyright

# 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.

# 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.



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