Export Tax Incentives—What Happens Next

By Michael Cornett and Ben Woodson

Tax incentives to encourage exports from the United States have taken many forms over the years including the Western Hemisphere Trading Corporation, Domestic International Sales Corporation ("DISC"), and the Foreign Sales Corporation. Currently, the Code provides two types of export tax incentives, the Interest-Charge Domestic International Sales Corporation ("IC-DISC") and the Foreign-Derived Intangible Income ("FDII") deduction. This article will provide an overview of the mechanics for each incentive and compare and contrast the incentives including an example comparing the potential benefits. Finally, the article will highlight potential tax legislation that will impact these two incentives.

IC-DISC Basics

In 1971, Congress enacted the DISC provisions. Under this regime, the DISC earns a deemed commission from a related supplier (*i.e.*, distributor or manufacturer) of U.S. export property. While the commission is fully deductible by the related supplier, the DISC pays no federal income tax on its commission income. When the income is distributed to the DISC's shareholders as a dividend, the shareholders pay tax at the applicable rate. In the case of individual shareholders, DISC dividends are taxable at capital gains rates.[1] In 1984, when the Foreign Sale Corporation regime was enacted, the DISC provisions were modified to impose an interest charge on deferred earnings (*i.e.*, earnings that had not been distributed to DISC's shareholders) in excess of $10 million and thus, the IC-DISC came into existence.

An IC-DISC is a C-corporation formed to act as a sales commission agent for a related distributor or manufacturer of U.S. export property. Figure 1 shows a simple illustration of an IC-DISC structure.[2]

For a corporation to be treated as an IC-DISC, it must meet the following requirements[3]:

1. Must be a corporation incorporated under the laws of any state or the District of Columbia;
2. Have only one class of stock;
3. Must have capital of $2,500;
4. Maintain a set of books and records separate from the related exporter; and

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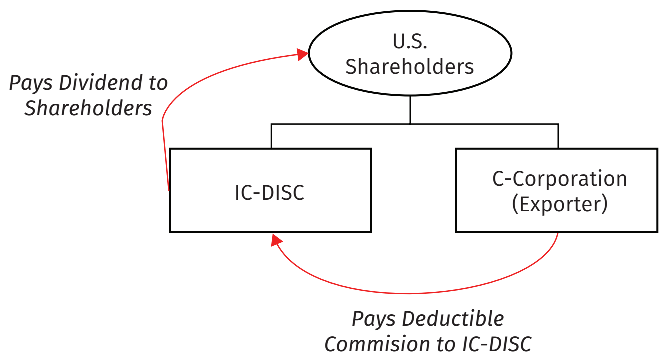
FIGURE 1.



5. Must file Form 4876-A, *An Election To Be Treated as an Interest Charge DISC*, within 90 days from the beginning of the tax year or incorporation to claim tax benefits for that year.

An IC-DISC is not required to maintain a physical place of business, have any employees, or actually engage in foreign export sales.[4] Thus, most IC-DISCs are corporations with minimal substance that are created purely for U.S. federal income tax purposes.

Once an IC-DISC is formed it must meet the following requirements on an annual basis[5]:

1. 95% of its gross receipts must be qualified gross receipts;
2. 95% of its assets must be qualified export assets[6];
3. Maintain $2,500 capital on each day of the tax year;
4. Commission payments by the related supplier to the IC-DISC must be paid on a timely basis;
5. Maintain its books and records; and
6. Timely file the IC-DISC income tax return, including international boycott reporting if applicable.

The gross receipts of the IC-DISC must be at least 95% "qualified gross receipts." Qualified gross receipts are receipts from[7]:

1. Sale, exchange or other disposition of export property;
2. Lease, license, or rental of export property;
3. Related and subsidiary services to the sale, lease, license, or rental of export property;
4. Dividends from a related foreign export corporation;
5. Interest on obligations that qualified export assets; and
6. Engineering and architectural services for construction projects outside the United States.[8]

Generally, "export property" is property that is manufactured, produced, grown, or extracted in the United States by a person other than the IC-DISC. It is held in the ordinary course of business for use, consumption, or disposition outside of the United States. Further, no more than 50% of the fair market value of the property can be attributed to materials imported in the United States.[9]

An IC-DISC can act as a commission-based entity or a buy-sell entity. The commission between the IC-DISC and the related supplier can be calculated using one of three methods: (i) 4% of qualified export receipts ("4% Method"), (ii) 50% combined taxable income ("CTI Method") generated by qualified export receipts, or (iii) apply Code Sec. 482 principles. The 4% Method and CTI Method are typically used as the IC-DISC generally does not perform any economic functions or have any employees. In the case of a buy-sell IC-DISC, it can increase its commission by 10% of its export promotion expenses.[10] The 4% Method and CTI Method cannot be applied to cause the related exporter to have a tax loss for the taxable year. Thus, if the related exporter is in a tax loss position before paying the IC-DISC commission, no commission can be paid to the IC-DISC and thus, no deduction.

The pricing method chosen can be done on transaction-by-transaction basis. Both methods can be applied in the same year but to different transactions. It is possible to make an election to group transactions in accordance with products or product lines. In general, the CTI Method produces a larger benefit than the 4% Method unless the products have a low profit margin, in which case the 4% Method should provide a better result.

FDII Basics

The Tax Cuts and Jobs Act created a new export tax incentive in Code Sec. 250 known as the FDII deduction.[11] Effective for taxable years beginning after

December 31, 2017, Code Sec. 250 allows a deduction for a domestic corporation that earns income falling within certain categories of income as defined in the statute and underlying regulations.[12] Requiring a series of complex and technical computations, the FDII deduction is generally computed by identifying the corporation's income streams that are "foreign-derived" within the statutory definitions, allocating and apportioning deductions to such income, and comparing this net amount of foreign-derived income to the corporation's total net income (including both domestic and foreign income, less certain adjustments) to arrive at the corporation's foreign-derived ratio. This foreign-derived ratio is multiplied by the corporation's deemed intangible income ("DII")[13] to calculate the amount of FDII. The FDII amount is multiplied by a statutory rate of 37.5% to determine the FDII deduction. Note, this deduction percentage will decrease from 37.5% to 21.875% for tax years beginning after December 31, 2025.

To take a FDII deduction, a taxpayer must be a domestic corporation, derive income from foreign persons or foreign markets, and have taxable income for the tax year. As stated above, the amount of a corporation's FDII is determined by multiplying the DII by the ratio of its Foreign-Derived Deduction Eligible Income ("FDDEI") divided by the Deduction Eligible Income ("DEI").

DII is the amount by which the corporation's DEI exceeds its Deemed Tangible Income Return ("DTIR").[14] DEI is the excess of the corporation's gross DEI less properly allocable deductions (including taxes).[15] Gross DEI means the gross income for the year *excluding* the following six categories of income:

1. Subpart F income inclusion;
2. GILTI inclusion;
3. Financial services income (as defined in Code Sec. 904(d)(2)(D) and Reg. §1.904-4(e)(1)(iii));
4. Dividend income received from a controlled foreign corporation (CFC);
5. Domestic oil or gas extraction income; and
6. Foreign branch income (includes a pure branch or a foreign entity classified as a branch for U.S. tax purposes).

The DTIR is 10% of the domestic corporation's qualified business asset investment ("QBAI") for the year.[16] QBAI for FDII purposes is the average of the domestic corporation's total adjusted basis, determined on a quarterly basis, in its "specified tangible property" used in its trade or business.[17] The adjusted basis in any specified tangible property must be determined using the alternative depreciation system ("ADS") under Code Sec. 168(g) and by allocating the depreciation deduction with respect to such property for the domestic corporation's taxable year ratably to each day during the period in the taxable year to which such depreciation relates.[18]

Specified tangible property means any "tangible property" used in the production of gross DEI.[19] Tangible property for this purpose means property for which the Code Sec. 167(a) depreciation deduction is eligible to be determined under Code Sec. 168.[20] If the property was used in the production of gross DEI and the production of income that is not gross DEI (*i.e.*, dual use property), then a *pro rata* portion of the property is treated as specified tangible property.[21]

Once the DII has been determined, the FDDEI must be determined. The regulations generally classify FDDEI transactions into two categories: FDDEI Sales and FDDEI Services. Each of these categories is further classified into subcategories, with specific rules applicable to each subcategory. Special rules exist under Reg. §1.250(b)-6(c), (d) to clarify if related party sales/services qualify as FDDEI.

Ultimately, the decision of whether to implement an IC-DISC or take advantage of the FDII deduction is complex and involves fact-pattern specific modelling and analyses.

FDDEI Sales are sales of general property, including digital content, or intangible property to a recipient that is a foreign person for a foreign use.[22] A "sale" includes any sale, lease, license, exchange, or other disposition of property.[23] A "sale" also includes any transfer of property in which gain or income is recognized under Code Sec. 367(d)(4).[24] General property includes any property other than: (i) intangible property; (ii) a security; (iii) an interest in a partnership, trust, or estate; or (iv) certain types of commodities.[25] Whether a sale of general property is for foreign use is determined by analyzing the specific facts and circumstances under the rules of Reg. §1.250(b)-4(d)(1).

FDEEI Services are income derived in connection with services provided to any person, or with respect to property, located outside the United States. More specifically, Reg. §1.250(b)-5(b) provides that an "FDDEI service" is the provision of:

1. A general service to a consumer's location of residence outside the United States;
2. A general service to a business recipient to the extent the service benefits the business recipients' operations outside the United States[26];
3. A proximate service to a recipient located outside the United States[27];
4. A property service with respect to tangible property located outside the United States[28]; or
5. A transportation service to a recipient, or with respect to a person or property located outside the United States.

A primary limitation of the FDII deduction is that the amount of deduction taken by the taxpayer is limited by the amount of the domestic corporation's taxable income. Under the 2020 final regulations, a taxpayer is allowed to limit their Code Sec. 250 deduction by any reasonable method so long as it is applied consistently for all taxable years beginning on or after January 1, 2021. Reasonable methods could include the proposed regulations' ordering rule or simultaneous equations.[29] Prior to the passage of the 2020 final regulations, taxpayers were required to apply a series of complex ordering rules to the corporation's taxable income to determine the amount of FDII limitation.

Compare and Contrast IC-DISC Versus FDII

The IC-DISC and FDII are export incentive regimes for activities conducted in the United States for markets and customers outside the United States. Table 1 highlights some of the major differences between the two regimes.

Based on Table 1, one would expect the FDII regime to provide a larger benefit than the IC-DISC regime based on the fact that the FDII regime has broader categories of income that can qualify for the benefit. Set forth below is an example that illustrates the benefits of both regimes separately and when combined. In this example, Taxpayer, a domestic corporation, has total gross sales of $2,000 with $250 from domestic sales and $1,750 from FDDEI sales. Included in the $1,750 of FDDEI sales is $1,000 sales that would qualify as gross receipts from qualified export property. Taxpayer's QBAI is $1,000. Table 2 calculates the tax under the IC-DISC regime, the FDII regime and IC-DISC/FDII regimes combined, assuming all E&P of the Taxpayer is distributed after corporate and IC-DISC taxes are paid.

While this simple example shows that the combination of the IC-DISC and FDII regimes can provide a greater benefit than either one operating independently, modelling would be necessary to determine the impact of utilizing an IC-DISC in conjunction with the FDII deduction as every dollar of an IC-DISC commission results in a decrease in the FDII deduction.

TABLE 1.

	IC-DISC Regime	FDII Regime
Who can claim benefit	Domestic corporations (including S corporations) and partnerships, and shareholders of IC-DISC.	Domestic C corporations.
Sale of property requirements	Requires sale of export property manufactured/produced in the United States and foreign materials cannot exceed 50% of the fair market value of the property.	Requires sale of property to a foreign person for foreign use. No U.S content or U.S. manufacturing requirement.
Income from qualifying services requirements	Limited to engineering or architectural services for construction projects, services related and subsidiary to qualified export receipts, and managerial service related to production of qualified export receipts.	Broader definition of services for any person, or with respect to property, located outside the United States; four categories of services: Proximate, Property, Transportation, and General (consumer and business recipient).
Sales to U.S. based distributors	Allowed provided such distributors export the property outside the United States in the time frame prescribed.	Requires property to be sold directly to a foreign person and for foreign use.
Calculation of benefit	Three different methods for calculating the benefit; 4% Methods and CTI Method can be used on the same tax return on a transaction by transaction basis.	Uses algebraic, residual formula to calculate FDII.
Nature of the benefit	Converts ordinary income into qualifying dividend income for shareholders of IC-DISC.	Reduce effective tax rate on FDII to 13.125%.

TABLE 2.

	Domestic Sales	FDDEI Sales	Qualifying Export Sales	Tax without IC-DISC or FDII	Tax with IC-DISC Only	Tax with FDII Only	Tax with IC-DISC and FDII
Gross Sales	$250	$750	$1,000	$2,000	$2,000	$2,000	$2,000
COGS	($100)	($200)	($300)	($600)	($600)	($600)	($600)
SG&A	($50)	($150)	($200)	($400)	($400)	($400)	($400)
Net Income	$100	$400	$500	$1,000	$1,000	$1,000	$1,000
10% of QBAI						$100	$100
IC-DISC Commission		—			($250)[1]		($250)
FDII Deduction	—					($304)[2]	($211)[3]
Taxable Income				$1,000	$750	$696	$539
Corporate Tax (21%)				$210	$157	$146	$113
Tax on IC-DISC Dividend (23.8% rate which includes net investment income tax)					$59		$59
Tax on remaining E&P distributed from C corporation as a dividend (23.8% includes net investment income tax)				$188	$141	$203	$152
Total Tax				**$398**	**$357**	**$349**	**$324**

1 CTI Method (50% of $500).
2 (1) $1,000 (DEI) – $100 (10% QBAI) = $900 (DII); (2) $900 × (900 (FDDEI) / 1,000 (DEI) = $810 (FDII); (3) $810 (FDII) × 37.5% = $304.
3 (1) $750 (DEI) – $100 (10% QBAI) = $650 (DII); (2) $650 × ($650 (FDDEI) / $750 (DEI) = $563 (FDII); (3) $563 × 37.5% = $211.

Future of Export Tax Incentives

Export tax incentives are under attack. The Biden Administration's *Made in America* tax proposal repeals the FDII regime.[30] Further, the FDII regime may also be in violation of World Trade Organization rules.[31] While there is no proposal to repeal the IC-DISC regime, the IC-DISC regime could be impacted as the Biden administration has proposed raising the corporate tax rate to 28% and the highest individual rate to 39.6%, including the rate at which capital gains are taxed.[32] If one includes the tax on net investment income of 3.8%, the statutory rate on a distribution from an IC-DISC will be 43.8%. While these proposals if enacted would reduce the IC-DISC benefits available to taxpayers, there would still be a benefit under the regime. Using a similar fact pattern as previously used, the IC-DISC benefit is reduced by approximately 7% in the example below (*see* Table 3).

Conclusion

Ultimately, the decision of whether to implement an IC-DISC or take advantage of the FDII deduction is complex and involves fact-pattern specific modelling and analyses. However, this complexity may soon be eliminated as it relates to the FDII regime under the Biden Administration's proposed U.S. tax reform. Although tax rates are likely to rise, there should still be a benefit from the IC-DISC regime for those who can qualify for the regime. Given the proposed rate increase and the flexible requirements for ownership of an IC-DISC, this may result in a renewed emphasis on utilizing the regime for gift/estate planning, compensation planning, and retirement planning for closely held businesses. For publicly traded corporations, the regime may be able to provide a deferral benefit which can minimize proposed changes in the GILTI regime.

TABLE 3.

	Domestic Sales	Qualifying Export Sales	Tax without IC-DISC	Tax with IC-DISC
Gross Sales	$1,000	$1,000	$2,000	$2,000
COGS	($300)	($300)	($600)	($600)
SG&A	($200)	($200)	($400)	($400)
Net Income	$500	$500	$1,000	$1,000
IC-DISC Commission				($250)
Taxable Income			$1,000	$750
Corporate Tax (28%)			$280	$210
Tax on IC-DISC Dividend (43.4% rate which includes net investment income tax)				$108
Tax on remaining E&P distributed from C corporation as a dividend (43.4% includes net investment income tax)			$312	$234
Total Tax			**$592**	**$552**

ENDNOTES

1 The highest capital gains rate for individuals is currently 20%.

2 The exporter also can be an S-corporation or a partnership. The shareholders of the IC-DISC do not have to be owners of the exporter and can be non-U.S. shareholders.

3 Reg. §1.992-1(a).

4 Reg. §1.992-1(a).

5 Reg. §1.992-1(a)-(d).

6 Qualified export assets under Code Sec. 993(b) include export property; assets used primarily in connection with the sale, lease, or other specified activities relating to qualified export property, and in connection with performing certain services; sufficient cash required to meet the working capital requirements; and amounts on deposit in the United States used to acquire other qualified export assets.

7 Reg. §1.993-1.

8 Excluded are receipts from export property that is ultimately used in the United States, sale is accomplished by a subsidy of the U.S. government, or the export property is for the use of the U.S. government, if the use is required by law or regulation.

9 Code Sec. 993(c).

10 Reg. §1.994-1(a)(2); *see also Computervision Corp.*, 6 TC 652. Export promotion expenses include general, administrative, and selling expenses, certain freight costs, and packaging costs incurred by the IC-DISC for export products.

11 Code Sec. 250.

12 On March 6, 2019, Treasury published proposed regulations providing guidance in determining the FDII deduction. On July 9, 2020, Treasury released the final Code Sec. 250 regulations, which generally apply to taxable years beginning on or after January 1, 2021. However, taxpayers may choose to apply these final regulations for taxable years beginning on or after January 1, 2018.

13 A corporation's deemed intangible income ("DII") is generally equal to the corporation's total net income less its deemed tangible income return ("DTIR").

14 Code Sec. 250(b)(2)(A); Reg. §1.250(b)-1(c)(3).

15 Reg. §1.250(b)-1(c)(2).

16 Code Sec. 250(b)(2)(B); Reg. §1.250(b)-1(c)(4).

17 Reg. §1.250(b)-2(b).

18 Reg. §1.250(b)-2(e)(1).

19 Reg. §1.250(b)-2(c)(1).

20 Reg. §1.250(b)-2(c)(2).

21 Reg. §1.250(b)-2(d).

22 Reg. §1.250(b)-4(b).

23 Code Sec. 250(b)(5)(E).

24 Reg. §1.250(b)-3(b)(16).

25 Reg. §1.250(b)-3(b)(10).

26 This can include advertising services and electronically supplied services.

27 Defined as services where substantially all the service is performed in the physical presence of the recipient.

28 Defined as services provided with respect to tangible property where substantially all services must be performed at the location of property and must result in physical manipulation of the property.

29 Reg. §1.250(b) Preamble III.

30 Senator Whitehouse's *No Tax Breaks for Outsourcing Act* also repeals the FDII regime. Senator Wyden's Overhauling International Taxation would modify the FDII regime.

31 *See e.g.*, Aldonas G., *The WTO Consistency of the Deduction for FDII*, TAX NOTES (Feb. 25, 2019).

32 The proposal to raise the corporate tax rate to 28% is in Biden Administration's *Made in America Plan* and the 39.6% rate is in *The American Families Plan*.