IC-DISC Strategies Update: Commissions, Complex Computations, IRS Audit Risks, Tax Savings Tactics

THURSDAY, OCTOBER 5, 2017, 1:00-2:50 pm Eastern

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Using DISCs to reduce US tax on US exporting companies and their foreign shareholders

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Using DISCs to reduce US tax on US exporting companies and their foreign shareholders

BY NEAL J. BLOCK

Since 1971, the US Tax Code (Sections 991-997) has reduced US tax on US exports through a US company called a Domestic International Sales Corporation (DISC). The DISC reduces US taxation on exports of US property manufactured, produced, grown or extracted in the United States for direct use outside the United States. Certain engineering and architectural services for construction projects located outside the United States, along with certain related and subsidiary services, also qualify.

The income which a DISC earns reduces the taxable income of a related US exporting company. The DISCs income is exempt from tax until it is distributed or deemed distributed (under the DISC provisions, DISC income attributable to gross receipts over $10m is deemed distributed. However as discussed below, the amounts deemed and actually distributed possibly can be taxed at no greater than 15 percent). A DISC can be an arm's-length company which earns income in accordance with normal arms-length principles. However it can also receive so-called safe-harbour income from qualified transactions with a 'related supplier'. The DISC safe-harbour income generally is the greater of 4 percent of gross receipts or 50 percent of combined taxable income from qualifying transactions (generally the DISC safe-harbour income cannot create a loss in a related supplier. However, there are exceptions where the export transactions are less profitable than domestic transactions).

DISC dividends to foreign shareholders considered to be individuals or individual partners of a partnership, should be taxed at a maximum of 15 percent on the DISC dividends.

The DISC originally was intended to be a deferral of tax, i.e., the DISC income deferred from tax eventually would be subjected to dividend income treatment at ordinary rates to its shareholders. Commencing in 2004, however, amendments to the Code taxed dividends from qualified corporations, including DISCs, at capital gains rates at a maximum of 15 percent to non-corporate shareholders (see Section 1(h)(11)(B)). This allows taxation of an unlimited amount of export profits to be permanently reduced from an effective rate of approximately 35 percent to an effective rate as low as 15 percent.

Generally shareholders of DISCs who may benefit from the 15 percent capital gains rate are either trusts or individuals which are entitled to the 15 percent rate on capital gains. So-called C corporation shareholders generally are not eligible for the 15 percent rate. Rather for those corporations the capital gains rate is the same as on ordinary income. As discussed below, however, some foreign corporations may be entitled to claim reduced US tax rates on DISC dividends.

Taxation of DISC foreign shareholders under Section 996(g)

When the DISC provisions were passed, Congress anticipated that certain non-resident aliens of the United States would be acquiring DISC stock. Because Congress intended for DISC shareholders to be taxable at ordinary dividend rates on DISC distributions, it included section 996(g) in the Code. That section provides that dividends received by non-resident alien individuals, foreign corporations, trusts or estates are to be treated as income effectively connected with a US trade or business conducted through a permanent establishment in the United States. Rather than applying the treaty rate on dividends related to portfolio investments, DISC dividend distributions are treated as if the recipient received the dividend from engaging in a US trade or business. When the DISC provisions were first passed and amended in 1984, the 996(g) provisions generally were considered to prevail over any contrary treaty provisions. Even though there was no treaty override in the Code provisions, the later in time of a Code provision or a treaty provision will prevail where the Code and the treaty have inconsistent provisions (see *Whitney v. Robertson*, 124 U.S. 190, 194 (1888)). Thus, for a number of years, DISC dividends were treated as effectively connected income because most tax treaties did not post-date the 1984 amendments to section 996(g). Foreign shareholders, therefore, commonly were subject to taxation on DISC dividends at normal tax rates of 35-45 percent or even higher.

Impact of capital gains treatment to foreign shareholders

The 2004 Code amendments to make dividends from a qualified corporation to its shareholders subject to capital gains treatment should also benefit DISC dividends by being taxed at the same 15 percent rate. Thus foreign entities which are individuals or entities treated as partnerships of individuals for federal income tax purposes appear to be eligible for 15 percent maximum capital gains rate. Since the Code provisions were designed to retain the treatment of DISC dividends in the hands of foreign shareholders, the same as fully taxable dividend income in the hands of US shareholders, applying the 15 percent rate is consistent with the intent of the DISC provisions.

Consequently, DISC dividends to foreign shareholders considered to be individuals or individual partners of a partnership, should be taxed at a maximum of 15 percent on the DISC dividends. The same would appear to be applicable to foreign trusts which are not for US income tax purposes treated as business associations taxed as corporations.

Check-the-box election to deem foreign corporations to be US partnerships

As discussed above foreign entities, treated as corporations for US income tax purposes do not appear eligible for the 15 percent capital gains rate since US corporations are taxed on capital gains at the 35 percent ordinary income rate.

One way for a foreign corporation to take advantage of the 15 percent rate would be for it to elect to convert itself for US income tax purposes from a corporation to a partnership with individual shareholders. Under the so-called check-the-box elections under Treas. Reg. § 301.7701-3, a foreign business entity which is not a so-called 'default corporation' (see Treas. Reg. § 301.7701-2(b)(8)) is eligible to elect partnership treatment. If it elects to be treated as a partnership, its partners who are individuals would be deemed to receive DISC dividends at the 15 percent capital gains rate.

Before an eligible foreign entity does a check-the-box election, however, it should determine whether or not the change in its US status from a corporation to a partnership or in some cases a disregarded entity would have other federal income tax consequences. If, however, there are no further adverse tax consequences, the check-the-box election may be a convenient way for a foreign corporation to achieve 15 percent taxation on DISC dividends.

Another alternative would be for the individual shareholders of the foreign corporation who control the corporation to form a limited liability company (LLC) treated as a partnership for US income tax purposes. The LLC would then hold the stock of the DISC. In that manner the individual shareholders would have limited liability and still be able to treat the DISC dividends as dividend income subject to the 15 percent rate.

Tax treaty provisions to reduce dividend taxation may be applicable

Despite the language of section 996(g) there are a number of treaties which have come into effect subsequent to the last amendment to section 996(g) of the Code. Those treaties in many cases are inconsistent with the deemed permanent establishment which is found in section 996(g). Under those treaties, there can be no permanent establishment in the absence of an actual physical presence in the United States. Therefore, the language which deems a treaty country person to have a permanent establishment in the United States may be inconsistent with and thus overruled by the treaty.

There is nothing in the Code or the legislative history to the Code which specifically states that the provisions of 996(g) are intended to override existing federal income tax treaties that are later in time to the 996(g) provisions. Consequently, if a treaty's language prevents a permanent establishment, the treaty provisions regarding normal dividends paid in the absence of a permanent establishment should result. To determine whether an existing treaty does override the provisions of section 996(g) of the Code requires an analysis of the specific treaty provisions.

Perhaps more important is the treatment of DISC dividends under the laws of the DISC's foreign shareholders. If DISC dividends or deemed distributions to a foreign shareholder are subject to foreign tax at a high rate, the benefits of the lower US tax rate may be lost. If, however, foreign taxation of DISC dividends is relatively low, relying on the treaty could save substantial taxes in the context of having DISC commissions reduce taxable income of the US exporting company by 50 to 100 percent, while being distributed to the treaty company shareholder at an effective rate of 5 or 10 percent or less. ■

Neal J. Block
Partner
Chicago, Illinois
T: + 1 (312) 861 2937
E: Neal.J.Block@bakernet.com

Neal J. Block has represented US clients on a broad range of domestic and international tax issues for more than 40 years. He is listed among Illinois' Superlawyers for 2008 and 2009, and has been consistently named a leading Illinois attorney by the Law Bulletin since 1997.