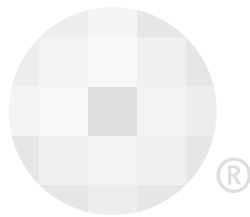


The IRS Audit Guide for IC-DISCs: Defending Your Client's Tax Savings on Exports

By Robert J. Misey, Jr.

Robert J. Misey examines the IC-DISC Audit Guide, a guide book for IRS agents when dealing with an IC-DISC in an exporter's group.



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For the last 10 years, IC-DISCs have been the hottest tax planning technique for U.S. manufacturers that export products. The process for procuring tax savings is relatively easy.

A closely held exporter—typically an S corporation or an LLC—or the exporter's owners form an IC-DISC. An IC-DISC does not pay corporate income tax.¹ The exporter pays a commission to the IC-DISC, which is deductible from income that would otherwise flow through to the individual owners of the exporter at almost a 40-percent rate. Subsequently, the IC-DISC distributes a dividend on which its owners incur income tax at the qualified dividend rate of 20 percent. These income tax savings of almost 20 percentage points can be even greater if the exporter is a C corporation.

Due to the popularity of IC-DISCs, the number of Forms 1120-IC-DISC that taxpayers file has increased over 50 percent² in the recent years for which data is available. At the beginning of the growth of the popularity of the IC-DISC, IRS agents never audited IC-DISCs, often ignoring an IC-DISC that a taxpayer owned. Recently, the IRS finally “discovered” IC-DISCs and prepared an IC-DISC Audit Guide for its agents that the IRS revised in each of the two subsequent years. Although some of the concepts that the Audit Guide discuss do not have anything to do with the vast majority of IC-DISCs formed, the Audit Guide provides a playbook to IRS agents, who during audit have ceased ignoring the presence of an IC-DISC in an exporter's group.

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The Audit Guide begins by introducing the tax rules for operating an IC-DISC. The latter part describes how International Examiners (IEs) should proceed with audits of IC-DISCS.

Tax Rules for Operating an IC-DISC

A taxpayer organizes an IC-DISC by forming a corporation with \$2,500 of par value stock and filing a Form 4876-A within 90 days of incorporation. The IC-DISC must further satisfy two tests: (1) 95 percent of its receipts must be qualified export receipts, and (2) 95 percent of its assets must be qualified export assets. An IC-DISC satisfies both of these tests by receiving a commission from an exporter for the exporter's sale of qualified export property.³

Although there are several different types of receipts that qualify for IC-DISC benefits, the typical qualified export receipt is for the sale of qualified export property. There are three requirements for a product to constitute qualified export property⁴: (1) the product must be manufactured in the United States by a person other than the IC-DISC (the "manufacturing test"); (2) the product must be held primarily for sale or disposition outside of the United States (the "destination test"); and (3) the product must have a minimum of 50 percent U.S. content (the "content test").

The commission income of an IC-DISC from the exporter's sales of qualified export property is an amount generally constituting the greater of either (1) four percent of qualified export receipts⁵ (*i.e.*, gross exports), or (2) 50 percent of the combined taxable income (CTI) from

qualified export receipts⁶ (*i.e.*, the operating margin on gross exports). Exporters may even further refine the use of CTI by only deducting marginal costs from gross exports and this marginal costing CTI is limited by the overall profit percentage on all sales.

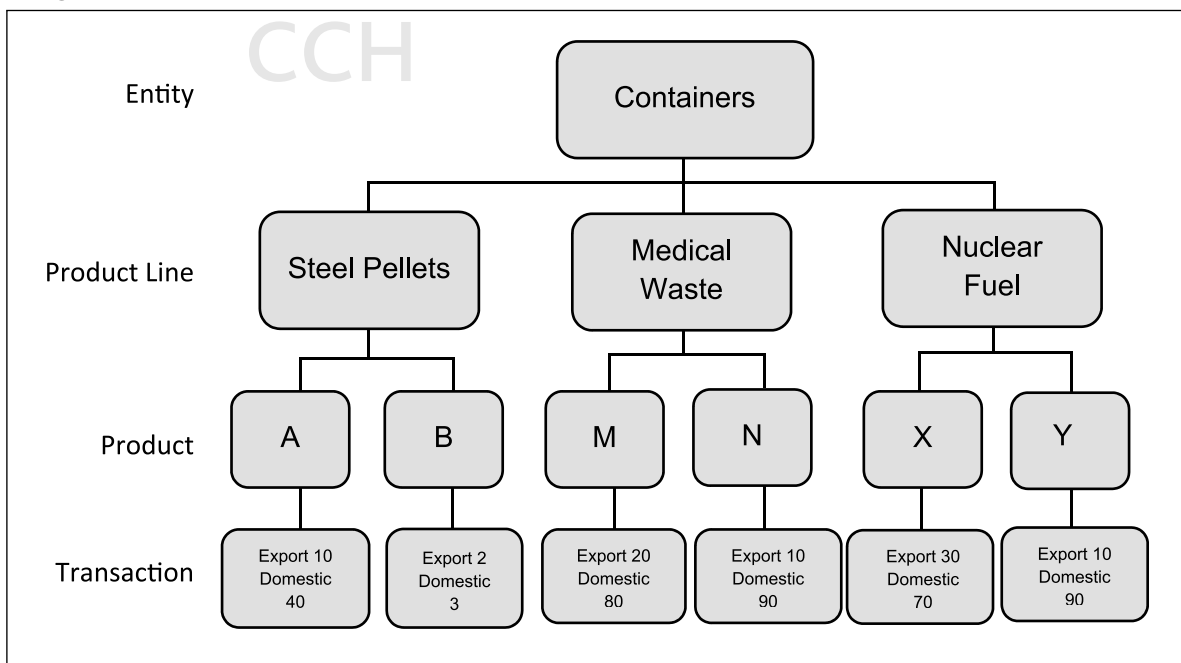
Exporters can use either method to maximize the commission and may even use one method for a grouping of qualified export receipts and another method for a different grouping of qualified export receipts. More specifically, grouping allows exporters to maximize the IC-DISC's commission by separating high-margin sales from low-margin sales. Exporters have considerable flexibility in grouping. The IRS will accept an exporter's product or product line grouping if the grouping conforms to recognized trade or industry usage (at least a two-digit major group of Standard Industrial Classification codes).⁷ Further mixing and matching occurs as an exporter can use grouping for one product line and the transaction-by-transaction method for another product line.⁸

Audits of IC-DISCS

Before discussing how to audit particular substantive issues, the Audit Guide emphasizes learning the taxpayer's business.

The Audit Guide advises the IEs to begin the audit by reviewing the exporter's Form 4876-A, Form 1120-IC-DISC and, in particular, the Schedule P. Reviewing the appropriate forms filed is fairly standard. However, in addition to reviewing the prior audit report in learning the taxpayer's business, the Audit

DIAGRAM 1



Guide instructs the IEs to review the instructions to the Form 1120-IC-DISC. Apparently, the authors of the Audit Guide believed that the instructions provide insight that the Audit Guide does not.

The Audit Guide tells the IEs to track the Schedule P to the workpapers. The Schedule P is the key part of the Form 1120-IC-DISC, showing how the exporter determined the commission, as the bigger the commission the bigger the tax benefit. Moreover, the Audit Guide recommends analyzing the various groupings used on the different Schedule Ps. In particular, the Audit Guide advises the IEs to review the matching of expense categories, determine which divisions export the different products in those divisions, and determine the sub-product lines.

The auditing of four substantive issues receives significant attention: the apportionment of expenses, the grouping of transactions, the determination of qualified export property, and refund claims.

Apportionment of Expenses

The apportionment of expenses is critical as exporters may maximize their CTI and, consequently, their commissions by apportioning more expenses to domestic sales than export sales. Accordingly, the Audit Guide discusses audits of this issue more than any other issue.

The IRS wants its IEs to evaluate the judgments used in apportioning expenses between export sales and domestic sales. As a result, the Audit Guide advises IEs to look at profit and loss statements as well as balance sheets for both divisions and product lines. The Audit Guide specifically asks that the IEs focus on three questions.

First, are the expense allocations reasonable? If the exporter's expense apportionments are not reasonable, the IE must further inquire as to why they are not reasonable.

Second, did the exporter follow the rules⁹ for apportionment of expenses? If not, the IE should evaluate how the CTI and, consequently, the commission changes if the exporter had properly followed the rules.

Third, does the end result seem illogical? For example, if domestic sales have an operating margin of one percent, but export sales have an operating margin of 30 percent, the Audit Guide reasons that the exporter is doing something improper.

The IC-DISC Audit Guide specifically discusses three sub-issues that relate to expense apportionment. First, a taxpayer using the completed contract method of accounting must include period costs of both current and prior years in determining their CTI.¹⁰ Second, all research and development expenditures must be attributable to all income reasonably connected with the

taxpayer's relevant three-digit Standard Industrial Classification category.¹¹ Third, an exporter must allocate gross interest expenses against all income earned—the exporter cannot net gross interest expense against gross interest income before apportionment.¹²

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Grouping

By grouping, exporters can increase their commissions and, consequently, the IC-DISC benefits by separating sales of low-margin products from sales of high-margin products. The Audit Guide initially tells the IEs to ask the following questions:

- What is the product or product line?
- Can a taxpayer track CTI from its books and records for the product or product line?

The Audit Guide provides various hypotheticals for grouping that consider Diagram 1, which illustrates an exporter that sells containers for steel pellets, medical waste, and nuclear fuel.

The Audit Guide explains that the exporter could conduct grouping by various levels, which would result in one Schedule P if done by the entity, three Schedules P if done by the product lines, six Schedules P if done by the products, and 82 Schedules P if done by the transactions. The Audit Guide then goes into detailed examples of mixing and matching products and product lines. Although this author does not necessarily agree with the IRS conclusions reached in all these examples, the significant time spent in the Audit Guide on this issue is a lesson to forewarn all exporters playing games with groupings.

In addition to the regular grouping rules for determining CTI, the Audit Guide also discusses the grouping rules for marginal costing. The general rule for marginal costing is that the grouping must be as broad as, or broader than, the overall profit percentage limit grouping. For example, when determining marginal costing for Product A, the overall profit percentage could be determined for either Product A or the broader grouping of steel pellets.

The grouping discussion closes by stating that an exporter may not group (for any purpose) by customer, by contract, or by country.¹³

Qualified Export Property

After apportionment and grouping, the Audit Guide advises the IEs to analyze whether the property sold is qualified export property. For example, the Audit Guide cautions IEs to examine the three aforementioned requirements for qualified export property and to look for specifically excluded sales of military property, most intangibles (except software), oil- and gas-related products, and some export sales to the U.S. government.

For the manufacturing test, the Audit Guide tells the IEs to request a description of the manufacturing process. The IC-DISC may not be the manufacturer of the product—qualified export property must be manufactured by another party—related or unrelated. Moreover, the Audit Guide provides advice to determine how, when, and where the taxpayer manufactured the item sold by suggesting that the IE review the exporter's annual reports, periodicals, and sales brochures. Oddly, the Audit Guide does not advise the IEs to examine any information obtainable on the internet, the easiest place to obtain information.

For the destination test, the Audit Guide tells the IEs to examine the movement of the property from the manufacturer to the customer. This line of inquiry should consider the method of shipment and the carrier's nationality to determine whether shipping documents exist to prove whether the product satisfied the requirement of leaving the United States within one year or whether benefits are lost because either the product was subject to further manufacturing before delivery outside of the United States or the product returned to the United States.

To prove delivery to a foreign destination within a year, the Audit Guide lists the documents that may exist regarding the shipment of products. These include (1) a copy of the exporter's bill of lading; (2) a certificate of the carrier showing delivery outside the United States; (3) a certificate of lading by a customs officer of a foreign country; (4) if there is not a customs officer's declaration, a written statement of the recipient; (5) a shipper's export declaration filed with the Bureau of Customs; or (6) other proof of the destination test. However, the Audit Guide does not offer any guidance as to what constitutes other proof.

The Audit Guide mentions the IE knowing the exporter's customers when auditing the destination test. In particular, the Audit Guide specifies scrutiny of sales to any U.S. customers. If, for example, the exporter's customer is a U.S. customer, the IE should further investigate to make

sure that the U.S. customer further exports the property on resale. These sales can qualify only as long as the U.S. customer resells the property without further manufacturing to a foreign customer, *but require further investigation*.

The Audit Guide advises the IEs to determine whether the property returns to the United States, which would fail the destination test. Furthermore, the Audit Guide tells IEs to analyze whether property does not qualify because it comes back to the United States within one year or is not used abroad in three years. Moreover, if the U.S. customer is a related customer, the Audit Guide tells the IE to confirm that the U.S. customer is not a related party that would double-dip benefits with a prohibited second IC-DISC.

For the content test of qualified export property, the Audit Guide merely advises the IEs to review customs invoices. Presumably, the IRS does not think that exporters are playing games with the content test.

Refund Claims

The Audit Guide closes the audit of the substantive issues portion by focusing on refund claims. Apparently, the IRS has realized that many exporters try to re-determine bigger commission expenses and increase their benefits when filing a claim for refund. As a result, the Audit Guide instructs IEs to determine whether the original return was audited or not and whether the refund claim includes changes to the exporter's groupings.

If the refund claim changes groupings, the Audit Guide advises the IEs to inquire as to how the exporter defines each new group. For example, this could be by the entity, product line, product, or transaction. The IEs are also supposed to ensure that the exporter has consistently applied the new groupings.

With respect to refund claims that ungroup—increasing the number of Schedules P as groups become smaller—the Audit Guide inquires as to whether the regulations permit the grouping and whether the exporter has sufficient data to calculate the commission for the new group.

Finally, the refund claim section focuses on whether additional sales result in the refund claim. If, for example, there are additional sales, the Audit Guide advises the IE to ensure that the sales are of qualified export property and to determine how the additional sales impact groupings.

What Is Not in the Audit Guide

Although the 72 unnumbered pages provide a thorough discussion of IC-DISCs, the Audit Guide lacks several items.

First, the Audit Guide offers little guidance with respect to the Form 4876-A. The Audit Guide does not tell IEs what they should look for when reviewing the Form 4876-A. Furthermore, the Audit Guide even mentions that it is not possible to retrieve the actual filed Form 4876-A from the archives of the IRS and, presumably, tax practitioners should expect IEs to request exporters to provide a copy of the previously filed Form 4876-A.

Second, the Audit Guide does not contain any instruction for IEs to audit the 95 percent of qualified export receipts test or the 95 percent of qualified export assets test. As aforementioned, these tests are not difficult for a typical IC-DISC to satisfy, but these tests are traps for the unwary as an inadvertent mistake by the taxpayer could easily disqualify the corporation as an IC-DISC.

Third, the Audit Guide does not include sample language for Information Document Requests (IDRs) on

Form 4564. Considering that IDRs are the primary means by which the IRS obtains information from taxpayers, tax practitioners can only hope for another version of this Audit Guide to see sample IDRs.

Conclusion

The IC-DISC Audit Guide does a fair job of describing an IC-DISC to the IEs and explaining the relevant issues on which an audit should focus. After many years of ignoring IC-DISCs, the Audit Guide achieves its goal of educating the IEs. Some of the issues raised are irrelevant to a typical IC-DISC, but the emphasis on auditing expense apportionment, grouping issues, and qualified export property is worthy. Any tax practitioner representing an IC-DISC under IRS audit must read and understand this Audit Guide. Doing so will enable the tax practitioner to properly plan to defend the IC-DISC.

ENDNOTES

¹ Code Sec. 991.

² From 1,209 in 2006 to 1,917 in 2008. Daniel Holik, *Statistics of Income Bulletin*, Summer 2011.

³ Code Sec. 992(a)(1).

⁴ Code Sec. 993(c). Other qualified export receipts include, for example, architectural and engineering service fees for projects located abroad and

exports of software.

⁵ Code Sec. 994(a)(1).

⁶ Code Sec. 994(a)(2).

⁷ Reg. §1.994-1(c)(7)(ii).

⁸ Reg. §1.994-1(c)(7)(iii).

⁹ Reg. §1.861-8.

¹⁰ *General Dynamics Corp.*, 108 TC 107, Dec. 51,961 (1997). This differs from the two-digit category

for a grouping for commission purposes.

¹¹ Reg. §1.861-8(e)(3).

¹² *Dresser Industries, Inc.*, DC-TX, 99-2 USTC ¶150,678, 73 FSupp2d 682 (1999), *aff'd*, CA-5, 2001-1 USTC ¶150,180, 238 F3d 603 (2001).

¹³ *Napp Systems, Inc.*, 65 TCM 2567, Dec. 49,022(M), TC Memo. 1993-196.

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