ALL EYES ON THE I.C.-D.I.S.C. PART TWO: I.R.S. EXAMINATIONS

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Tags
Expense Allocation
Exports
Combined Taxable Income
Grouping
I.C.-D.I.S.C.
I.R.S. Examinations

INTRODUCTION

The Interest Charge Domestic International Sales Corporation ("I.C.-D.I.S.C.") is an undervalued tax planning tool for exporters that can provide substantial tax advantages to U.S. export companies and their shareholders. The background, technical aspects, and tax benefits of the I.C.-D.I.S.C. are discussed in Part One, previously published in *Insights*.[1] Part Two of the I.C.-D.I.S.C. duology reviews the I.R.S. examination procedure and key aspects taxpayers should keep in mind, considering the growing number of I.C.-D.I.S.C. audits.

The number of I.C.-D.I.S.C. returns submitted was relatively low prior to the termination of the foreign sales company and extraterritorial income regimes and the reduction of individual tax rates on qualified dividends. Since 2004, the number of returns has steadily grown, catching the attention of the I.R.S. As a result, the I.R.S. released an I.C.-D.I.S.C. Audit Guide (the "Guidelines")[2] to assist I.R.S. examiners when reviewing tax returns of taxpayers claiming the benefit. Understanding what examiners will focus on also allows export companies to better structure I.C.-D.I.S.C. operations and tax calculations. This article explains important points in the Guidelines and their application to related suppliers that utilize an I.C.-D.I.S.C. to reduce taxes on export sales.

I.C.-D.I.S.C. REVIEW

In order for a corporation to qualify as an I.C.-D.I.S.C. (i) at least 95% of the gross receipts during the taxable year must qualify as export receipts and (ii) at least 95% of the total adjusted bases in assets at the close of the taxable year must consists of qualified export assets. An I.C.-D.I.S.C. can usually satisfy the first requirement through the receipt of a commission payment made by the export company. Because an I.C.-D.I.S.C. is typically established as a passive commission agent that receives fees and distributes dividends, typically the asset test is met.

The commission payment is computed by one of three methods: (i) the 4% of export gross receipts method – the easiest method to apply, (ii) the 50% of combined taxable income ("C.T.I.") method – more difficult to apply because export taxable income requires sophisticated computations, or (iii) the arm's length Code §482 method – which is rarely used as it requires the I.C.-D.I.S.C. to be fully staffed. The taxpayer can select the method that produces the highest commission, thereby generating the highest tax benefit. On the other hand, if a company operates without

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1. Bennet, Michael. "All Eyes on the I.C.-D.I.S.C. Part One: The Export Gift That Keeps On Giving," *Insights* Vol. 10 No. 2 (March 2023).
2. See here.

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a tax department and without a fully staffed I.C.-D.I.S.C., it may choose to use the method that is easiest to compute. The primary benefit of using an I.C.-D.I.S.C. today is converting ordinary income into a qualified dividend through the commission payment and its immediate dividend to individual shareholders, which is taxed at a preferential rate.

OVERVIEW OF THE GUIDELINES

The Guidelines place significant emphasis on the determination of (i) export property and qualified export receipts, (ii) apportionment of expenses, and (iii) the grouping of transactions.

The Guidelines advise examiners to determine whether the property sold is qualified export property. There are three requirements for a product to constitute qualified export property. First, the product must be manufactured in the U.S. by a person other than the I.C.-D.I.S.C. Second, the product must be held primarily for sale or disposition outside the U.S. Third, U.S. inputs must make up at least 50% of total inputs. Qualified export receipts consist primarily of revenue from the sale of export property.

The apportionment of expenses factors into how exporters maximize C.T.I., thereby leading to increased commissions and increased dividends taxed at 20% at the Federal level. One way C.T.I. can be increased is by apportioning a greater amount of expenses to domestic sales. However, that approach may be characterized as a fool's paradise as the I.R.S. is of the view that taxpayers often understate the allocation and apportionment of expenses to export sales. Consequently, the guidelines focus on this issue more than any other due to the complex nature of the calculations.

Generally, the determination of the I.C.-D.I.S.C.'s taxable income is performed on a transaction-by-transaction basis.[3] However, some or all of the computations may be made on the basis of grouping products or product lines.[4] An exporter can also use grouping for one product line and the transaction-by-transaction method for another product line.[5] Grouping allows exporters to increase commissions by separating sales of low-margin products from sales of high-margin products. Exporters generally have wide flexibility when grouping. The I.R.S. will accept an exporter's product grouping or product line grouping if it conforms to recognized trade or industry usage or the two-digit Standard Industry Classification ("S.I.C. codes").[6]

EXAMINATION PROCEDURE

The Necessary Forms

While it is essential for the taxpayer to properly execute and file the necessary forms, the examiner will also naturally pay special attention to the forms as the

[3] Treas. Reg. §1.994-1(b).

[4] Treas. Reg. §1.994-1(c)(7).

[5] Treas. Reg. §1.994-1(c)(7)(iii).

[6] Treas. Reg. §1.994-1(c)(7)(ii).

foundation for analyzing operations and the tax position of the I.C.-D.I.S.C. and its related supplier.

A corporation must elect to be treated as an I.C.-D.I.S.C. by filing Form 4867-A. The election must be made within 90 days after the beginning of the first taxable year of a newly formed corporation or during the 90 days immediately preceding the beginning of the first taxable year to which the election applies. The I.C.-D.I.S.C. must use the same tax year as that of its largest shareholder, determined by reference to voting power.[7]

"Each transaction or group of transactions that generate qualified export receipts requires a separate Schedule P."

The I.C.-D.I.S.C. files its return on Form 1120-I.C.-D.I.S.C. The Schedule P of Form 1120-I.C.-D.I.S.C. is arguably the most important piece to the auditing puzzle as it is used to calculate the commission payment made by the related supplier to the I.C.-D.I.S.C. The examiner will review the related supplier's books and records in order to assess the accuracy of the Schedule P.

Each transaction or group of transactions that generate qualified export receipts requires a separate Schedule P. Together, the aggregate of all such schedules comprise the total C.T.I. from the sale of export property.[8] For commission I.C.-D.I.S.C.'s, C.T.I. equals the export company's gross receipts from sales of export property, reduced by the export company's expenses (excluding commissions paid to the I.C.-D.I.S.C.) and the I.C.-D.I.S.C.'s expenses related to the gross receipts.

The Schedule P provides the following:

- Name of the I.C.-D.I.S.C.
- Employer identification number
- Identity of the product or product line reported on the schedule
- Type of transaction: transaction-by-transaction or grouping of transactions

The related supplier may combine transactions or groups of transactions on a single Schedule P, provided it maintains supporting schedules for each transaction or group of transactions.

Learning the Taxpayer's Business

The initial step in the examination process is for the I.R.S. examiner to gain an understanding of the related supplier's business and I.C.-D.I.S.C.'s role, which typically is passive. The examiner will review the products that are being sold and the manufacturing process of such products. The examiner's goal is to understand how, when, and where the products are manufactured. Attention is also paid to the selling function and the purchasers of the products. The examiner is instructed to conduct research on the taxpayer's industry to gain a wholistic understanding of the business. Ordinarily, an examiner will attempt to gather information independently. However, nothing prevents a taxpayer from proactively supplying industry statistics to ensure that favorable information is taken into account during the course of the examination.

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[7] Code. §441(h).

[8] Treas. Reg. §1.994-1(c)(6).

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Requesting the Tax Workpapers

Like most audits, the examiner will request the tax workpapers related to the preparation of the tax return and the computation of C.T.I. Most of the expenses incurred to generate the qualified export receipts are on the books of the related supplier, while the expenses that relate to export promotion by the I.C.-D.I.S.C., if any, will be on the books of the I.C.-D.I.S.C.

The examiner will review the income statements of the related supplier to assess the methodology used to allocate and apportion expenses to qualified export receipts. The goal of the examiner is to evaluate whether all direct and indirect expenses have been taken into account.

The examiner will also request accounting records including (i) divisional profit & loss statements and balance sheets and (ii) product line profit & loss and balance sheets. These are more typical for larger companies and reflect the accounting department's view of how expenses should be allocated on a book basis.

Following the review of the above information, the examiner will generally assess the following criteria:

- Are the tax workpapers and Schedule Ps on a tax basis or book basis?
- Are expenses that are allocated to qualified export receipts computed on a reasonable basis for the taxpayer's business?
- Are the end results comparable to similar products sold in the U.S.? For example, if qualified export receipts show a profit of 30% of sales, but similar products sold domestically have a profit of 5%, the examiner will look to reconcile the difference.

Export Property and Qualified Export Receipts

At this point the examiner is instructed to begin analyzing specified export property and qualified export receipts. The examiner will gather and review all the relevant facts and determine whether the sales generate qualified export receipts.

When analyzing the facts relevant to export property, the examiner will review the following:

- The property sold
- The manufacturing process:
  - Who manufactured the property?
  - Where was the property manufactured?
  - Did the manufacturing process occur at more than one location?
  - What is the country of origin for the raw material used to manufacture the property?

- ○ Did the manufacturing occur after the property was sold and before it was exported from the U.S.?
- ○ Is more than 50% of the value of inputs to export property imported into the U.S.?

- The movement of the property from the place of manufacture to the customer:
  - ○ Where was the property shipped from and which company was the carrier?
  - ○ What documents exist regarding shipment of the goods?
  - ○ Did the goods leave the U.S. within one year?
  - ○ Was the property subject to any further manufacturing, assembly, or other processing between the time of sale or lease and the delivery outside the U.S.?
- The customers
- Whether the property returned to the U.S. or if it can be expected to return to the U.S.
- Whether the property is disqualified from being export property, because it is proscribed in Code §993(c)(2).[9]

When analyzing the facts relevant to qualified export property, the examiner will also review

- whether the gross receipts are listed in Code §993(a)(1), and
- whether the gross receipts are excluded as qualified export receipts per Code §993(a)(2).[10]

Apportionment of Expenses and Computation of C.T.I.

Related suppliers can attempt to increase C.T.I. and D.I.S.C. commissions by allocating more expenses to domestic sales over foreign sales. To prevent abuse,

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[9] Excluded property includes: (i) property leased or rented by a DISC for use by any member of a controlled group (as defined in subsection (a)(3)) which includes the D.I.S.C., (ii) 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, (iii) products of a character with respect to which a deduction for depletion is allowable (including oil, gas, coal, or uranium products) under section 613 or 613A, (iv) products the export of which is prohibited or curtailed under section 7(a) of the Export Administration Act of 1979 to effectuate the policy set forth in paragraph (2)(C) of section 3 of such Act (relating to the protection of the domestic economy), and (v) any unprocessed timber which is a softwood.

[10] Excluded receipts are those receipts designated by the I.R.S. as: (i) arising from a transaction that is for ultimate use in the United States, (ii) accomplished by a subsidy granted by the U.S. or any instrumentality thereof, or (iii) for use by the United States or any instrumentality thereof where the use of such export property or services is required by law or regulation.

examiners are instructed to review the manner in which a taxpayer apportions expenses to domestic sales and export sales.

The examiner will use both judgement and actual data to assess whether the computation of C.T.I. is reasonable or requires further analysis. Particularly, the examiner will assess whether the end result complies with Treas. Reg. §1.861-8 (Computation Of Taxable Income From Sources Within The United States And From Other Sources And Activities).

The Guidelines provide examples where an extraordinary end result should be investigated further:

- The entire division had a profit of $10,000,000, but the sum of the profits on the C.T.I. statements, total $9,000,000, when the export sales are less than 50% of total sales.
- The widgets sold in the U.S. have a bottom-line profit of 5%, but when widgets are exported the bottom-line profit is 40%.

An extraordinary result does not automatically mean there should be an adjustment. Prices abroad may be higher than in the U.S. or the U.S. product is viewed to be a premium product in a particular foreign market. Nonetheless, higher profit margins for export suggest that the examiner may need to conduct further analysis. For the related supplier, the key is to adopt a reasonable methodology that is applied consistently and to maintain supporting documents that are part of the permanent tax work papers.

The examiner is encouraged to look at whether (i) certain categories of expenses were not allocated,(ii) other categories of expenses were allocated, but not on an unreasonable basis, and (iii) the product mix is different.

In addition to the above, the examiner will pay close attention to the following potential issues.

Is there a distortion of income that impacts the computation of C.T.I.?

In *General Dynamics Corp. v. Commr.*,[11] the taxpayer excluded certain period costs deducted prior to completion of the contract when computing C.T.I. A period cost is a non-inventoriable cost incurred and deducted in one year related to income recognized in a subsequent year. The taxpayer did not take into account the period costs deducted in a prior year when computing C.T.I. The court held that the taxpayer must account for period costs of both current and prior years in determining its C.T.I.

Example

A taxpayer incurs $100 of period costs on a three-year construction contract. The period costs are incurred $40 in year one, $30 in year two and $30 in year three. The taxpayer uses the completed contract method of accounting. The sale is booked in year three. Assume that 40% of the total sales contract generated qualified export receipts.

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[11] General Dynamics Corp. v. Commr., 108 T.C. 107 (1997).

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In the context of the facts above, the taxpayer argued that only the year three period costs should be allocated to C.T.I., so the taxpayer allocated (40% of $30) $12. The court held that the taxpayer's method resulted in a distortion and allocated (40% of $100) $40 to the C.T.I.

How were R&D expenses allocated by the related supplier?

In *Boeing Co. v. U.S.*,[12] the taxpayer divided its R&D into two broad categories: Blue-Sky and company sponsored product development which included product-specific research. Relying on Treas. Reg. §1.994-1(c)(6), the taxpayer treated all of the company sponsored product R&D as directly related to a single program, and as totally unrelated to any other program. For example, in the taxpayer's calculation of C.T.I., the cost of R&D directly related to the 767 model commercial airliner had no effect on the calculation of the C.T.I. produced by export sales of the other models.

The Supreme Court noted that Treas. Reg. §1.994-1(c)(6) allows the taxpayer to choose to group export receipts and the regulation establishes that there shall be an allocation and apportionment of all relevant costs deducted in the taxable year. However, the court held that Treas. Reg. §1.994-1(c)(6) does not speak to how costs should be allocated among different items or classes of gross income and apportioned between the I.C.-D.I.S.C. and export company once the taxpayer groups its gross receipts.

Example

The 727 was a new product line that did not generate any sales until year three. Sixt percent of the year three sales were exported. In years one to three, the program R&D expenses for the 727 were $100 per year. The $100 of Program 727 R&D expenses in years one and two should be allocated to all sales for all product lines not just sales of the 727 product line.

Are R&D expenses allocated to C.T.I. reduced by the portion of R&D subject to exclusive geographic apportionment?

R&D, like other deductions, is first allocated and then apportioned. The first step is to allocate R&D to product categories based upon the S.I.C. code. The second step is to apportion R&D between the statutory and residual grouping.

Once the R&D is allocated to a product category, it is apportioned under either the sales method or the gross income method. Each of those methods apportion a fixed percentage of the R&D to the geographic source where most of the R&D was performed. For most U.S. corporations, the portion of the R&D subject to the geographic source rule will be allocated to U.S. source income, since typically the R&D is performed in the U.S.

However, the C.T.I. calculation is not based upon whether the qualified export receipts generate U.S. source income or foreign source income. For purposes of computing C.T.I. related to export sales, the exclusive geographical apportionment rule is simply not applicable.[13]

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[12] *Boeing Co. v. U.S.,* 537 U.S. 437 (2003).

[13] Rev. Rul. 86-144.

Example

The R&D assigned to a product category is $1,000. Sixty percent of the sales in that product category generate qualified export receipts. The taxpayer can use the sales method, and under the assumed facts, $500 is allocated to U.S. source income to the determine the foreign source income. However, the source of export income is not relevant to the computation of C.T.I. The R&D allocated to C.T.I. would be 60% of $1,000 or $600.

In apportioning interest income to export sales, does interest income reduce interest expense when computing C.T.I?

The issue here is whether, when allocating interest expenses to C.T.I., the related supplier must allocate gross interest expense or may it reduce interest expense by interest income and allocate only the net amount of interest expense.

In *Bowater v. Commr.*,[14] the Second Circuit reversed the Tax Court, and held that the plain language of Treas. Reg. §1.861-8(e)(2) controls. Under the regulation, interest expense must be allocated on a gross basis when computing C.T.I.

If export accounts receivable are factored by the related supplier, does this affect the computation of qualified export receipts and C.T.I.?

If an export company factors receivables from export property at a discount, then the discount reduces the qualified export receipts for purposes of computing I.C.-D.I.S.C. profits under the 4% and 50% commission pricing methods.

Did the related supplier recognize losses for the year?

The examiner will look to how a loss was allocated by the taxpayer, keeping in mind that neither the 4% gross receipts method nor the 50% C.T.I. method may be applied to cause a loss in any taxable year to the related supplier.[15]

How are currency gains and losses allocated to C.T.I. and were any variances allocated to qualified export receipts?

In Field Service Advice 199935008,[16] a U.S. subsidiary of a foreign parent manufactured export property in the U.S. and sold the export property to foreign purchasers through a commission F.S.C. The F.S.C. did not take title to the export property. Rather, the it was paid a commission for its services. Sales receipts for the exported property were denominated in foreign currency. Consequently, the U.S. subsidiary hedged the export receivables in order to minimize dollar denominated earnings volatility.

For purposes of determining C.T.I., the losses on the forward sale of foreign currency were required to be taken into account. Under Treas. Reg. §1.861-8(b)(2), a deduction is considered to be definitely related to a class of gross income and therefore allocable to that class if it is incurred as a result of, or incident to, an activity, or in connection with property, from which such class of gross income is derived. Where a deduction is incurred as a result of, or incident to, an activity or in

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[14] *Bowater v. Commr.,* 108 F.3d. 12 (2d Cir. 1997).

[15] Treas. Reg. §1.994-1(e)(1).

[16] This F.S.A. relates to foreign sales corporations. However, the analysis is under Treas. Reg. §1.861-8, which also applies to I.C.-D.I.S.C.'s.

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connection with property which the activity or property generates, has generated, or could reasonably have been expected to generate gross income, the deduction is considered to be definitely related to that gross income as a class, whether or not (i) there is any item of gross income in that class received or accrued during the taxable year or (ii) the amount of deductions exceeds the amount of the gross income in that class. The taxpayer raised various arguments that the losses on the forward sale of foreign currency should have been allocated to potential gains of one kind or another, but not to the export sales income. However, the I.R.S. expressed the view that the foreign currency losses were factually more closely related to the export property receivables which the foreign currency contracts hedged.[17]

Grouping

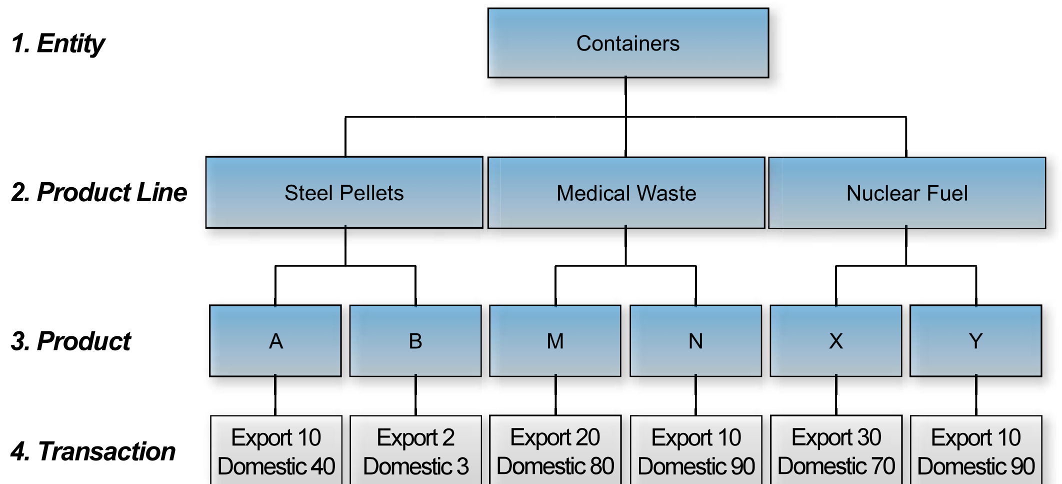
If a taxpayer groups products or product lines to prepare Schedule P of Form 1120-IC-DISC, the taxpayer must be prepared to answer two questions in the case of an examination:

- What is a product line?
- Can a C.T.I. statement be constructed from the taxpayer's books and records for the product or product line?

The first question is answered by applying the S.I.C. Codes or recognized trade or industry usage standard. The second question is answered by a review of the taxpayer's books and records.

The taxpayer can prepare income statements for each of the four levels (entity, product line, products, and transactions). All of the income statements can track the specific sales, direct material costs, direct labor costs, normal applied overhead, and inventory. The below-the-line expenses are allocated by the tax department.

The Guidelines provide several scenarios detailing what are acceptable and unacceptable grouping procedures using the below diagram and example.



[17] Under Code §6110(k)(3), an F.S.A. cannot be used or cited as precedent by any person other than the taxpayer involved. However, an F.S.A. tends to demonstrate the views of the National Office of the I.R.S. as of the date issued and can be cited by others for the limited purpose of avoiding certain penalties.

In the example, the taxpayer's business is the design, manufacture, and sale of different kinds of containers. The containers store steel pellets, medical waste, and nuclear fuel. Each of these product lines contains two products. Some of the receipts qualify as qualified export receipts. Because the taxpayer has qualified export receipts, it must decide how to place them on Schedule P of the I.C.-D.I.S.C.

Using the example, the Guidelines indicate that the taxpayer has several grouping options, which would result in the following:

- **If performed on an entity basis:** One Schedule P. Total of all 82 export transactions.
- **If performed on a product line basis:** Three Schedule Ps: steel (total of 12 export sales), medical (total of 30 export sales) and nuclear (total 40 export sales).
- **If performed on a product basis:** Six Schedule Ps. For example, steel pellets would have two schedule Ps – product A (total of ten export sales) and product B (total of two export sales). The same idea would apply to medical and nuclear, each of which would have two products.
- **If performed on a transaction-by-transaction basis:** Eighty-two separate Schedule Ps for each export sale.

Taxpayers may also group by marginal costing in addition to the typical grouping rules. The grouping rules for marginal costing involve the computation of the Overall Profit Percentage Limitation ("O.P.P.L.").[18] For purposes of the marginal costing O.P.P.L., the grouping must be at least as broad as the one used to compute the full costing C.T.I.

Continuing with the example above, consider the ten export transactions for product A. Assume that the taxpayer places the first nine on separate Schedule Ps. The tenth transaction has a full costing profit of 1%. To compute the O.P.P.L. for the tenth transaction, the taxpayer can use either (i) all 50 transactions for product A, (ii) the sum of all of the transactions in product A (50 transactions) plus product B (five transactions), or all 455 transactions of the entire container division. The marginal costing rules are subject to a no-loss rule, and for that reason, the profit on the tenth sale cannot exceed the full costing C.T.I.

Lastly, the examiner will review whether any of the grouping are prevented by the regulations.[19]

- A sale transaction cannot be grouped with a lease transaction.
- Qualified export receipts from related and subsidiary services, which are booked in the same taxable year as the export property, can be grouped with the sale or lease to which they relate.

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[18] O.P.P.L. is computed by multiplying the qualified export receipts by the overall profit percentage. The overall profit percentage equals (full costing C.T.I. for I.C.-D.I.S.C. and export company both domestic and export of a product or product line)/(domestic and export sales of the product or product line).

[19] Treas. Reg. §1.994-1(d).

- Qualified export receipts from related and subsidiary services which are not booked in the same taxable year as the export property are subject to a different rule. These qualified export receipts can be grouped with the products or product lines to which the services relate, so long as the grouping of services chosen is consistent with the grouping of products or product lines for the taxable year in which the export property was sold.
- Qualified export receipts from engineering or architectural services are treated on a transaction-by-transaction basis.
- Qualified export receipts from an I.C.-D.I.S.C. rendering managerial services to an unrelated I.C.-D.I.S.C. is treated on a transaction-by-transaction basis.
- The following groupings are not allowable groupings under Code §994:
  - Customer groupings
  - Contract groupings
  - Product or product line groupings within customer or contract groupings
  - Country-by-country

CONCLUSION

While the Guidelines provide examiners with a road map to conduct audits of I.C.-D.I.S.C.'s, they are equally important for export companies utilizing I.C.-D.I.S.C.'s as they highlight the primary areas examiners will review. As part of the lead-up to a sale, prudent taxpayers should thoroughly analyze their determinations of export property and qualified export receipts, how they apportion expenses to domestic and foreign sales, and the manner in which they group transactions. Waiting to perform the analysis until after the year closes and tax returns are prepared can be suboptimal as what-if calculations may no longer be relevant as the facts already exist, and even if choices can be made, there may not be time for full analysis. These key areas comprise the central factors when commission payments and tax benefits are calculated. Having a full understanding of the rules, risks, and issues will assist the taxpayer in achieving the desired tax benefits provide comfort in the event an I.R.S. examination is initiated.

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