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TAX IMPACT

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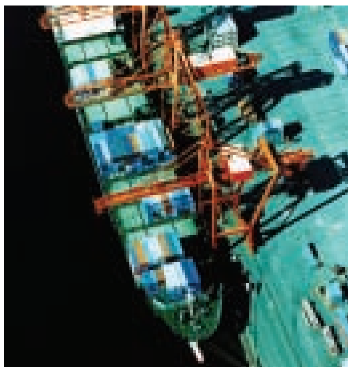
Last of the red-hot export incentives?

Businesses can use the IC-DISC to cut their tax bills

The repeal of the extraterritorial income exclusion (EIE) has renewed interest in a little-used export incentive: the interest-charge domestic international sales corporation (IC-DISC). Privately held companies with significant export sales can use an IC-DISC to slash their tax bills — and, for some, the tax savings will even exceed the benefits available under the EIE.



IC-DISC makes a comeback

Since the early 1970s, the U.S. government has tried to help American companies compete abroad by offering tax breaks for exporters, such as the domestic international sales corporation, foreign sales corporation and EIE. But the World Trade Organization and European Union have challenged every one, calling them illegal export subsidies.

In response, the United States passed the American Jobs Creation Act of 2004, which phased out the EIE between 2004 and 2006 while phasing in a new deduction for "domestic production activities" (also known as the manufacturers' deduction) from 2004 through 2010. Once it's fully phased in, the deduction will effectively reduce the top corporate income tax rate for qualifying producers from 35% to 32%.

The repeal of the EIE has sent exporters looking for alternatives. A key reason the IC-DISC is being viewed as an attractive one is the Jobs and Growth Tax Relief Reconciliation Act of 2003, which reduced the maximum tax rate on qualified dividends from 20% to 15% through 2008. More recently, the Tax Increase Prevention and Reconciliation Act of 2005 extended the reduction through 2010.

By making tax-deductible "commission" payments to an IC-DISC, an exporter can convert large amounts of ordinary income — taxable at rates as high as 35% — into dividend income taxed at 15%.

Eligibility

An IC-DISC is a tax-exempt "paper" corporation set up to receive commissions on export sales. If the exporter is an S corporation, limited liability company or partnership, it can form an IC-DISC as a subsidiary. C corporation exporters must have individual shareholders (usually the exporter's shareholders) set up the IC-DISC to realize the tax benefits.

In addition to being a U.S. corporation, an IC-DISC must satisfy a number of technical requirements, such as:

- Elect to be treated as an IC-DISC for tax purposes,
- Maintain a minimum capitalization of $2,500,
- Have a single class of stock,
- Meet a 95% qualified export assets test, and
- Meet a 95% qualified gross receipts test.

To pass the qualified gross receipts test, at least 95% of the IC-DISC's gross receipts must consist of commissions related to qualified export property — that is, property:

1. Manufactured, produced, grown or extracted in the United States,
2. Held primarily for sale, lease or rental for direct use, consumption or disposition outside the United States, and
3. Whose value is not more than 50% attributable to imported materials.

Although the exporter must actually transfer cash commissions to the IC-DISC, the IC-DISC isn't required to have separate offices or employees or perform any services. As far as the exporter's customers are concerned, the IC-DISC is invisible.

Tax savings

An exporter is permitted to pay commissions to an IC-DISC up to the greater of 4% of its gross receipts

from sales of qualified export property or 50% of its net income on those sales. The exporter deducts the payments, but the IC-DISC is exempt from tax on the commission income.

The IC-DISC has the ability to defer tax on up to $10 million in commission payments in exchange for modest interest payments to the IRS (hence the "interest charge" or "IC" designation). Most important, commissions distributed to the exporter or individual shareholders are treated as dividends and taxed at the 15% qualified dividend rate.

For example, EXP Inc., an S corporation, earns $1 million in net income on $15 million in qualifying export sales. EXP forms an IC-DISC as a subsidiary, paying it a $600,000 annual commission (4% of $15 million). EXP deducts the $600,000 commission payment, avoiding $210,000 in ordinary income taxes (assuming the highest 35% rate). When the commissions are distributed as dividends from the IC-DISC, its shareholders pay a 15% tax — or $90,000. By forming an IC-DISC, EXP saves $120,000 a year in federal income taxes.

Don't let it slip by

It's possible the European Union will challenge the IC-DISC, though many experts view that as unlikely because it isn't available to large publicly traded corporations.

Even if a challenge is brought, it could be several years before the dispute is resolved, so take advantage of this export incentive's low cost and potentially significant tax savings while you can.

Shredding personal records

With year end rapidly approaching you may be cleaning through records wondering what to save and what to toss. Here are some general guidelines to help you determine which records you must hold on to. Before you start, check with your tax and legal advisors. If you don't, you may get rid of something you really need to keep.

Personal records	1 year	3 years	7 years	Permanent
Bank statements and deposit slips			X	
Brokerage statements (year end), investment purchase and sale records, mutual fund annual statements, and dividend reinvestment records			X[1]	
Brokerage and mutual fund statements (monthly and quarterly)	X			
Credit card statements			X	
Estate planning documents				X
Home improvement records (canceled checks, receipts, etc.)			X[1]	
Home purchase documents			X[1]	
Insurance policies (other than life)			X[2]	
IRA and retirement plan documents and statements				X
Legal documents				X
Life insurance policies				X
Loan records/Forms 1098			X[1]	
Medical bills (insurance-related)		X		
Medical bills (tax-related)			X	
Medical records				X
Paycheck stubs (until you reconcile them with your W-2)	X			
Tax returns				X
Tax return supporting documents (canceled checks, receipts, charitable contribution documentation, etc.)			X	
W-2s and 1099s			X	

[1] After ownership period or loan term ends
[2] After policy expires

Why Dec. 31 should be your personal tax deadline

Some tax-saving strategies must be implemented before year end

Most people spend a significant portion of their earnings on income taxes — often more than any other single expense. Yet it's not unusual for them to put more effort into getting the best price on a new car than into reducing their tax bills.

One possible reason for this is that employer withholding and estimated payments take some of the sting out of the April 16 tax payment deadline. But just because you don't have to send a payment to the IRS next April doesn't mean you shouldn't take advantage of opportunities to save.

Getting out your crystal ball

To plan effectively, you need to gaze into your crystal ball and estimate your income, deductions and tax liabilities for both this year and next. There may be opportunities to shift income and expenses between 2006 and 2007, reducing your overall tax burden.

Although Congress may extend the higher exemption amount into 2007 or beyond, uncertainty about the AMT's future makes planning a challenge.

The rule of thumb is that you'll save money by deferring taxes as much as possible, for example, by accelerating deductions into this year or delaying income until next year. But that's not always the case. If you expect your marginal tax rate to be higher in 2007, it might make sense to do the opposite and pay more tax at this year's lower rate.

Your marginal rate could go up next year for any number of reasons, such as increased income bumping you into a higher tax bracket or causing you to lose deductions or exemptions that are phased out above certain income levels.

There are many ways to shift income and expenses between tax years. You can accelerate deductions by paying property taxes early or defer income by asking your employer to pay your year end bonus in 2007.

You may also benefit by "bunching" certain expenses into one year. For instance, medical expenses are deductible only to the extent they exceed 7.5% of your adjusted gross income. When you're close to the threshold and need additional medical treatment, schedule it in the year you expect your medical expenses to be higher. Before implementing these timing strategies, consider the alternative minimum tax (AMT).

Reviewing your investments

Take stock of your investment portfolio because you may want to sell some of the losers to offset capital gains you've already recognized this year from asset sales or mutual fund distributions. Remember, you can use net capital losses to offset up to $3,000 of ordinary income each year and carry over unused losses indefinitely to offset gains in future years.

One popular strategy is to sell securities at a loss and then replace them with the same securities. This allows you to generate tax deductions while keeping your

portfolio intact. But under the wash sale rule, this technique works only if you buy the replacement securities more than 30 days before or after the sale.

If you plan to contribute to charity this year, consider donating appreciated stock or other securities held for more than one year. Although there are limitations, you can typically take a charitable tax deduction for the stock's full fair market value while avoiding capital gains tax on the appreciation. If you're thinking about donating stock that's declined in value, however, you're better off selling the stock and donating the proceeds to charity. That way you can take a deduction for the capital loss and the charitable donation.

Taking a tip from TIPRA

The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), signed into law a few months ago, may affect your tax planning in several areas, including:

AMT. TIPRA increases the AMT exemption amount, for this year only, to $62,550 for married couples filing jointly and $42,500 for single taxpayers. As of this writing, next year the AMT exemption is scheduled to roll back to its pre-2001 levels of $45,000 and $33,750, respectively.

Although Congress may extend the higher exemption amount into 2007 or beyond, uncertainty about the AMT's future makes planning a challenge. Ordinarily, you'd look at strategies for avoiding or minimizing the AMT this year. But if the AMT exemption drops substantially next year, you might want to increase your AMT income this year to avoid even higher taxes next year.

Kiddie tax. A popular tax strategy for families is to shift investment income to children in a lower tax bracket, but TIPRA changes to the "kiddie tax" have limited this strategy's advantages. How? Dependent children under age 14 with unearned income exceeding $1,700 pay tax at their parents' marginal rate. TIPRA raises the age limit to 18, effective Jan. 1, 2006, with certain exceptions.

This change eliminates the advantages of shifting stocks and other income-producing assets to children over age 14. It also wipes out a tax windfall many families had planned to take advantage of in 2008. By postponing the sale of a child's portfolio until that year, when the capital gains rate for the lowest tax brackets drops to zero, they would have been able to cash out their investments tax free.

Keeping an eye on tax legislation

No matter how carefully you plan, lawmakers can change everything with the stroke of a pen. Congress may pass additional tax laws before the year winds down, so be sure to monitor legislative activity and be prepared to adjust your plan accordingly.

Can your kids also be your employees?

If you own a business, the most effective way to shift income to your kids is to hire them. You can deduct your kids' wages as a business expense and, if they're under age 18 and your company is unincorporated, you won't have to pay Social Security, Medicare or unemployment taxes.

Your kids are entitled to a standard deduction — currently $5,150 — which means their first $5,150 in earned income is tax free. The kiddie tax isn't an issue because it applies only to unearned income. Keep in mind that wages should be for a bona fide job and comparable to market rates. If you're paying too much, you could lose the deduction.

A GRAT way to transfer a family business

There are many estate planning techniques available to help you transfer your family business to the next generation at a low tax cost. For a pass-through entity that generates strong, predictable cash flow, the grantor retained annuity trust (GRAT) is a great tool to pass business interests to family members free of gift and estate taxes.

How you benefit

A GRAT is advantageous because it allows you to receive an annuity for a specified number of years and, at the end of the term, the remaining assets are transferred to your beneficiaries. Depending on the trust terms, the annuity amount is either a fixed percentage of the trust property's initial fair market value (FMV) or its FMV at a subsequent time. Because a GRAT is a "grantor trust," you pay income taxes on the trust's earnings.

As long as you outlive the trust, the assets remaining in the trust at the end of the trust term are removed from your estate and sheltered from estate taxes. If you don't survive the trust term, the assets will be brought back into your taxable estate.

How it works

When you transfer assets to a GRAT, you make a taxable gift to the trust's beneficiaries. The amount of the gift is the present value of your beneficiaries' remainder interest. Present value is determined using the Section 7520 rate, which is the IRS presumed rate of return on the GRAT assets.

By setting the annuity payments high enough so that their present value is equal to the value of the trust assets, you can reduce the gift amount to zero. To the extent that the trust assets outperform the Sec. 7520 rate, however, the additional appreciation passes to your beneficiaries free of estate tax.

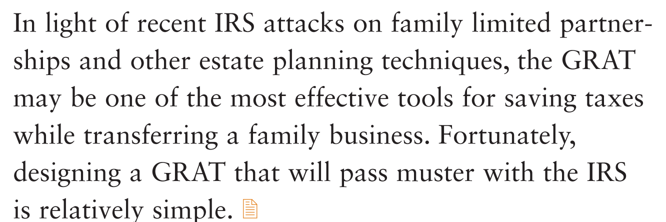
How you save

Let's say you're the sole shareholder of an S corporation that has an FMV of $15 million and distributes $2 million per year in dividend income. You transfer 40% of the stock to a 10-year GRAT for the benefit of your daughter. Assuming a 30% minority interest valuation discount, the FMV of the transferred interest is $4.2 million ($15 million x 40% x 70%).

Suppose you create the GRAT in a month when the Sec. 7520 rate is 6%. For a 10-year GRAT, an annuity of just under 13.59%, which generates a required annuity payment of $570,545, will result in zero gift tax. But the 40% interest is expected to earn $800,000 per year in dividends. If those dividends are generated, and as long as you survive the 10-year trust term, the GRAT will transfer the 40% interest in the business plus the difference between the dividend and annuity payments — more than $2.25 million — free of gift and estate taxes.

It's important for the business interest to generate enough cash flow to cover the annuity payments. If it doesn't, the GRAT will have to return a portion of the business interest to you, diminishing the tax benefit.

GRAT expectations



In light of recent IRS attacks on family limited partnerships and other estate planning techniques, the GRAT may be one of the most effective tools for saving taxes while transferring a family business. Fortunately, designing a GRAT that will pass muster with the IRS is relatively simple.

Tax Tips

Watch out for business use of "listed" property

Many business assets qualify for expensing or accelerated depreciation deductions. But special rules apply to "listed property," such as computers (if they're used away from the office), cars, cell phones, and certain audio and video equipment.

To qualify for accelerated depreciation or expensing, listed property must be used more than 50% for business and it must pass that test for each year during the cost-recovery period.

If business use drops below 50%, you may have to recapture excess deductions taken in previous years and pay tax on those amounts. To avoid unpleasant surprises, monitor the use of listed property and keep detailed records showing that business use is more than 50%.

Beware of tax scams

The IRS recently published the 2006 "Dirty Dozen" — this year's installment of its annual list of the most notorious tax scams. The list includes several well-established scams, including misuse of trusts, abuse of charitable organizations and offshore transactions. A couple of new scams have also made the list: "Zero wages" and "Form 843 tax abatement," both of which involve filing IRS forms to claim that tax bills have been wrongly inflated.

New school of thought on avoiding estate taxes

In a recent private ruling, the IRS gave passing marks to a novel estate planning technique: prepaying tuition. It allowed a taxpayer to prepay tuition for his six grandchildren through 12th grade, without triggering estate, gift or generation-skipping transfer taxes — and without using up any of his exemptions.

Taxpayers have always been able to bypass transfer taxes by paying tuition on behalf of children and grandchildren, provided the payments are made directly to the school. But if you're concerned about living long enough to pay tuition expenses as they're incurred, this new technique allows you to pay for several years of schooling in advance, removing large sums of wealth from your taxable estate.

For this strategy to work, the payments must be nonrefundable, so be sure to check the terms of the school's prepaid tuition program. Remember that your family will forfeit the money if your student drops out or changes schools.

Investor or trader?

For most people, investment expenses are considered miscellaneous itemized deductions, which are tax-deductible only to the extent they exceed 2% of adjusted gross income. In addition, the deduction for investment interest — that is, interest on debt you incur to buy or carry an investment — is generally limited to your net investment income.

These limitations don't apply to traders. Keep in mind that you might qualify as a trader if you devote enough time to buying and selling securities, and execute a large enough volume of trades. To find out if you're eligible for the tax benefits available to traders, consult your tax advisor.

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Certified Public Accountants

Dear reader,

President Bush has just signed the "Tax Increase Prevention and Reconciliation Act of 2005" (TIPRA) which had been passed earlier by both houses of Congress. The measure will provide approximately 70 billion of tax relief to a variety of taxpayers. It offers tax reductions for individuals by extending through 2010 the 15% preferential tax rates on long term capital gains and qualified dividends. It also increases the Alternative Minimum Tax exemption and also has IRA related provisions. TIPRA also offers tax reductions for businesses, extending through 2009 the election to expense (rather than depreciate) as much as $100,000 of property used in a trade or business, and make off-the-shelf computer software eligible for such immediate expensing. Unfortunately, TIPRA also adds tax-raising provisions to the Tax Code.

Morrison, Brown, Argiz & Farra takes great pride in offering comprehensive tax counseling to preserve wealth, optimize taxes and maintain state and federal compliance.

We offer much more than standard compliance work. Our goal is to work closely with our clients to make sure that they are taking advantage of the many tax planning strategies available. We also want to ensure that they are in compliance with income tax laws and assist in preparing all necessary tax returns.

We would be pleased to discuss the provisions of TIPRA and invite you to contact us with any questions you may have.

Sincerely,

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