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Tax code offers export incentives—but don't push too far

TAXING MATTERS
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As President Trump talks about reforming the tax code to incentivize exports, it is important not to forget a powerful tool that the existing tax code offers to exporters.

By creating an "interest charge domestic international sales corporation" or DISC, exporters can significantly reduce their tax bill on qualified sales overseas.

The advantages of this technique are highlighted by a recent court ruling upholding its use to fund a Roth IRA.

Congress designed DISCs to incentivize companies to export goods by deferring and lowering their taxes on export income. To take advantage of these rules, exporters must establish the DISC as a separate company.

Rather than export goods directly, they do so with the assistance of the DISC, which charges a commission on export sales. Generally, the commission is equal to the greater of 4 percent of gross receipts or 50 percent of combined taxable income, though other methods are sometimes used.

There are two advantages to using this structure. First, the DISC does not have to pay tax on its income. The exporter gets to deduct the commission payment, but the DISC does not pay tax on the commission received. Thus, use of this structure reduces the exporter's current tax bill.

Second, when the income is distributed from the DISC, it is taxed at dividend rates. Under current law, these are 15 percent for qualified dividends as compared to the maximum federal ordinary income rate of about 35 percent. Not only is the payment of tax deferred, but when it is paid, it is paid at the lower rate.

When the commissions are paid, a pool of cash will develop in the DISC. The law allows the DISC to loan the funds back to the exporter for use in its business. The exporter must use the money to increase its inventory, equipment, machinery, plant, etc. by an amount equal to the loan by the end of the year of the loan or for R&D. This approach allows exporters to use the tax savings to reinvest in the business.

A recent tax case decided by a federal appeals court highlights the significant tax savings that can result from creative use of DISCs—as well as the perils, and potential rewards, of aggressive tax planning.

The case, Summa Holdings v. Commissioner, involved the use of DISCs to circumvent the annual funding limitations on Roth IRAs. Like DISCs, Roth IRAs are congressionally created vehicles designed to incentivize particular activity, in the case of Roth IRAs, savings for retirement. Eligible taxpayers can make contributions to these accounts and enjoy tax-free growth and tax free distributions in retirement. Contributions, however, are capped at $5,500 per year.

Most DISCs are owned by the same people that own the underlying company. However, in this case, the business owners arranged for their children's Roth IRAs to purchase shares in a holding company owning the DISC for a nominal sum. When the DISC paid dividends from the commissions it received, they went to the IRAs.

Over about a decade, the DISC paid $6 million of commission income to the IRAs, much more than the $5,500 that the IRS would have allowed the siblings to contribute to the accounts on their own each year.

Unsurprisingly, the IRS attacked this strategy. It said that the tax benefits that the family generated by combining a DISC with a Roth IRA were not intended by Congress. The IRS said that the strategy was designed to evade the contribution limits on Roth IRAs. It applied the "substance over form" doctrine to recharacterize the transactions as dividends paid by the DISC followed by Roth IRA contributions.

The tax court sided with the IRS. However, in a sweeping, strongly worded decision issued last month, the Sixth Circuit reversed.

It said that the congressionally sanctioned purpose of both the DISC and Roth IRA provisions is tax avoidance and that there was nothing wrong with using them for that purpose: "The commissioner cannot fault taxpayers for making the most of the tax-minimizing opportunities Congress created."

The court strongly criticized the IRS for overreaching, and took a narrow view of the "form over substance" doctrine that the IRS tried to use against the taxpayer. "Form is substance," the court said, "when it comes to the law."

To date, the IRS has not stated whether the ruling will be appealed. There are similar cases pending before appeals courts in other circuits, including the Second Circuit, which includes New York. An appeal to the Supreme Court seems likely.

The case is an illustration of the tremendous power of Roth IRAs and DISCs to create tax savings. However, this is not to say that taxpayers should follow the lead of the family in the case. The appeals court's decision was a surprise, and in my personal view, the Supreme Court and the other circuits will shut this strategy down. IRA-DISC transactions remain listed transactions, which means that the IRS has flagged them as potentially inappropriate tax shelters that must be specifically disclosed on tax returns.

When it comes to tax, if it sounds too good to be true, it probably is. Except if Congress says it isn't.

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