Tax Incentives For Exported Ag Products

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Overview

The Tax Code contains two significant provisions allowing farmers to derive a tax benefit from exporting ag products. One incentive is derived from the creation of an entity known as the Interest Charge Domestic International Sales Corporation (IC-DISC). An IC-DISC is a tax-exempt entity that was authorized by the Congress in 1971 to provide a tax incentive to help address the U.S. trade deficit at the time. It was restructured in 1984 into its present form. The Tax Cuts and Jobs Act (TCJA) added another export tax incentive that can also be available to agricultural producers – the Foreign-Derived Intangible Income (FDII) deduction. *I.R.C. §250*.

The IC-DISC, the FDII deduction and potential tax benefits for farmers and ranchers – it's the topic of today's post.

IC-DISC Basics

An IC-DISC allows a farmer that will be selling into an export market to essentially transfer income from the farmer to the tax-exempt IC-DISC via an export sales commission. An IC-DISC can be formed and utilized by any taxpayer that manufactures, produces, grows or extracts (MPGE) property in the U.S. that is held primarily for sale, lease or rental in the ordinary course of the taxpayer's trade or business. That definition certainly includes farmers. The property to be exported is transferred to the IC-DISC which then sells the assets into an export market.

An IC-DISC has as its statutory basis I.R.C. §§991-997. It is a corporate entity (not an S corporation) that is separate from the producer, manufacturer, reseller or exporter. To meet the statutory definition of an IC-DISC, the entity must have 95 percent or more of its gross receipts consist of qualified export receipts, and the adjusted basis of the qualified export assets of the IC-DISC at the close of the tax year must equal or exceed 95 percent of the sum of the adjusted basis of all of the IC-DISC assets at the close of the tax year. Also, the IC-DISC cannot have more than a single class of stock and the par (stated value) of the outstanding stock must be at least $2,500 on each day of the tax year. In addition, the corporation must make an election to be treated as an IC-DISC for the tax year*. I.R.C. §992(a)(1).*

Properly structured, an IC-DISC is exempt from federal income tax under I.R.C. §991, and any dividends (actual and deemed) paid-out are qualified dividends that are taxed at a more favorable long-term capital gain rate by converting ordinary income from sales to foreign unrelated parties. *I.R.C. §995(b)(1).*

"Destination test." As noted above, the property at issue must be held for sale, lease or rental in the ordinary course of the taxpayer's trade or business for direct use, consumption or disposition outside of the U.S. This is known as the "destination test." This test is satisfied if the IC-DISC delivers property to a carrier or a party that forwards freight for foreign delivery. It doesn't matter when title passes or who the purchaser is or whether the property (goods) will be used or resold. The test is also met if the IC-DISC sells the property to an unrelated party for U.S. delivery with no additional sale, use assembly or processing in the U.S. and the property is delivered outside the U.S. within a year after the IC-DISC's sale. Likewise, the "destination test" is satisfied if the sale of the property is to an unrelated IC-DISC for the same purpose of direct use, consumption or disposition outside the U.S.

The "destination test," at least in the realm of agricultural products, has been made easier to satisfy with the advent of rules that require food tracing. This is particularly the case with fruits and vegetables. Growers can trace their products to grocery stores and other end-use foreign destinations. The same is true for grain producers that deliver crops to export elevators. They will likely be able to get the necessary documents showing the precise export location of their grain products.

IC-DISC income. The producer, manufacturer, reseller or exporter pays the IC-DISC a commission based on the amount of export sales for the year. *See Treas. Reg. §1.993-6(e)(1).* The commission paid to the IC-DISC (as a tax-exempt entity) is deductible and, as such, reduces the exporter's taxable income by the marginal tax rate of the commission amount. As noted, the commission is tied to the exporter's foreign sales or foreign taxable income for the tax year, and cannot exceed either 50 percent of net income on sales of qualified export property or four percent of gross receipts from sales from sales of qualified export property. *I.R.C. §994(a).* Both computations can be used on the same return if there are multiple transactions and grouping of transactions are allowed. *Treas. Reg. §1.994-1(c)(7).* Thus, the taxpayer can tailor the computational method and groupings to maximize the tax benefit of the IC-DISC.

The IC-DISC does not pay tax on the export sales because of its tax-exempt status.

The IC-DISC distributes its profits as qualified dividends to its shareholders. Qualified dividends are taxed at preferential capital gain rates – presently anywhere from zero to 20 percent for an active farmer.

Income deferral. Instead of paying tax currently in the form of a qualified dividend, the IC-DISC can also provide income deferral. Deferral is achieved by having each IC-DISC shareholder pay interest in an amount tied to the deferred tax liability associated with the IC-DISC times the base period T-bill rate. Each shareholder does their own computation. Thus, the ultimate tax liability of a shareholder will be determined by that particular shareholder's marginal tax rate. Tax can be deferred on commissions on up to $10 million per year in export sales that the IC-DISC conducts.

FDII

The FDII allows a domestic C corporation that sells into foreign markets to claim a deduction for those sales in the amount of 37.5 percent of foreign-derived intangible income. The actual computation of the deduction is quite complex. *See I.R.C. §§250(a)(1)-(2).* With the C corporate rate currently §set at 21 percent, the FDII effectively reduces that rate to 13.125 percent through 2025. Income qualified for the FDII deduction is that derived from the sales of property or inventory to foreign persons and for foreign use (including any lease, license, exchange or other disposition), and income derived from services to any foreign person or income from providing services with respect to property not located in the U.S.

Under proposed regulations, a business is to exclude from qualifying sales any products that are sold to a foreign customer that the taxpayer has reason to know would ultimately return to the U.S. for domestic use. But, recently promulgated final regulations that are effective for tax years beginning on or after January 1, 2021 remove this limitation. The final regulations also ease up on the documentation requirements concerning foreign use of property. While specific ordering rules apply under the proposed regulations when applying the interest limitation of I.R.C. §163(j), the final regulations specify that any reasonable method can be used to order allowed deductions. Other rules can apply when the property sold is later incorporated into another finished product, and when related parties are involved.

Is the IC-DISC Better Than the FDII Deduction?

Which tax incentive is better depends on the taxpayer and the type of export income. The IC-DISC applies to goods that are produced in the U.S. from U.S. materials. Agricultural commodities meet that requirement. There is no comparable requirement for the FDII deduction – there just has to be a sale of property to a foreign person for a foreign use. While that can be an important distinction for many businesses, it is largely immaterial for ag businesses. The FDII deduction also applies to a much broader range of service income than does the IC-DISC. Again, however, that distinction is not a material one for most ag production operations. Also, while a distributor can be used to sell ag products in the IC-DISC context, a taxpayer that sells U.S. MPGE products to a distributor who then exports the products cannot claim and FDII deduction. Only direct sales count. *See I.R.C. §250(b)(4).*

Conclusion

The IC-DISC and the FDII deduction are designed to incentivize export sales. Both provisions may be unheard of by many farmers and practitioners. However, they can play a role in the overall income tax planning and business structuring process. As part of an estate plan, if the IC-DISC shareholders are the younger members of the family, value can be transferred to them without triggering federal transfer taxes. In addition, the IC-DISC shareholders don't have to be involved in the farm business – they don't have to be engaged in manufacturing, production growing, exporting or reselling. Thus, off-farm heirs can be set-up as IC-DISC shareholders and receive at least a portion of their anticipated inheritance in that manner without being engaged in the farming operation. That will please the on-farm heirs (and, likely, the parents).

The FDII deduction is only available to C corporate taxpayers, but there are no entity formation, operational and administrative costs associated with it as there are with the IC-DISC.

Both provisions are complex and require competent tax and legal assistance to maximize their potential benefits.