

EXPORT TAX INCENTIVES AND THE PRODUCTION ACTIVITIES DEDUCTION

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ABSTRACT

Export tax incentives have been a part of the income tax landscape in the United States for more than 40 years, beginning with the Domestic International Sales Corporation. As various incentives have been declared invalid by international agencies, Congress has attempted different versions of these incentives. Only the relatively minor Interest Charge - Domestic International Sales Corporation (IC-DISC) remains. In 2004 Congress tried a new approach with the Domestic Production Activities Deduction (PAD). This incentive gives taxpayers a tax deduction for defined domestic production activities. The IC-DISC and the PAD are evaluated in light of tax policy considerations and found lacking.

INTRODUCTION

The United States government has taken a number of measures over the past four decades to encourage export activity. Several of these measures have taken the form of tax incentives for export activity. However, these measures have raised the ire of the European Union (EU) and other international bodies. Some have been found to be in violation of the General Agreement on Tariffs and Trade (GATT), others have run afoul of the rules and regulations of the World Trade Organization. Each time one of these has been found in violation, the U. S. Congress has gone “back to the drawing board,” so to speak, to seek an export incentive that will not violate international agreements. One export incentive, the Interest Charge – Domestic International Sales Corporation (IC-DISC) remains. It has been unsuccessfully challenged by the EU before the WTO. However, it is not an incentive that has found widespread application.

After the Exterritorial Income Exclusion (ETI) was struck down by the WTO in 2002, the United States took a different approach, enacting the Production Activities Deduction (PAD), or Section 199 of the Internal Revenue Code. This deduction did not focus on exports, but was designed to encourage domestic production and create new jobs within the United States.

This paper will examine export incentives that have not survived international scrutiny, along with the IC-DISC. It will then examine the basics of the PAD, and illustrate the significance of this deduction. The PAD and the IC-DISC will be evaluated in light of tax policy principles.

EXPORT INCENTIVES OF THE PAST

Over the last four decades there have been a number of attempts to promote export activities through the tax code. However, most of these have been found in violation of international agreements that the United States had signed. Congress passed the Revenue Act of 1971 creating Domestic International Sales Corporations (DISC), which provided a tax incentive to export. [4] Under provisions of this act, a DISC was not subject to U. S. corporate income taxes. [1] However, the DISC legislation soon ran into difficulties with the General Agreement on Tariffs and Trade (GATT), a trade agreement to which the United States was a signatory. Members of the European Union (EU) submitted a complaint to GATT that DISC was an export subsidy and in violation of Article XVI of the GATT. The United States filed a counter-claim that the “territorial tax” systems of France, the Netherlands, and Belgium conferred export subsidies. A GATT panel subsequently rendered a decision in 1976 declaring that both DISC and the territorial tax systems were in violation of GATT. [4]

The year 1984 saw the introduction of two export incentives to replace the discredited DISC. These included the Foreign Sales Corporation (FSC) and a variation of the DISC, the Interest Charge – Domestic International Sales Corporation (IC-DISC). Only the IC-DISC remains today. The FSC was designed to conform to GATT by providing an export tax benefit incorporating elements of the 1981 understanding based on findings from the GATT council [4].

In order to qualify as an FSC the corporation must have its main office in the United States or certain other qualified nations. It must have at least one director who is not a U. S. resident, maintain an offshore office, have no more than 25 shareholders, and file an election with the IRS. An FSC is entitled to an exemption on a portion of its earnings from the sale or lease of export property. This exemption can be as great as 15% on gross export income. [12] European countries were not fully satisfied of the GATT-legality of the FSC concept, but the controversy remained somewhat dormant until November, 1997. At this juncture, the EU requested consultations with the United States over FSC. This “consultation process” is the prescribed first step in the dispute settlement process under WTO. [4]

These consultations were unproductive, so the EU nations took the next step of requesting that a panel examine the issue. The panel generally supported the complaints of the EU, finding that FSCs violated subsidy obligations under the WTO Agreement on Subsidies and Countervailing Measures and the WTO Agreement on Agriculture. Understandably, the United States filed an appeal. However, the appeal was unsuccessful. [4] Having exhausted legal remedies, the United States had until October 1, 2000 to bring its systems into compliance or face sanctioning retaliatory measures from the WTO. An alternative to FSC was presented to the WTO, which was subsequently rejected. [4]

The source of the controversy lay in the fact that the United States generally taxes its resident corporations on their worldwide income. However, the FSC carved out a benefit that allowed a portion of FSC income to be defined as “not in the conduct of an active U. S. trade or business,” and therefore exempt from corporate taxation. Ordinarily, this could still be taxed when remitted to the U. S. based parent as an intra-firm dividend, but FSC provisions provide a 100% deduction for such dividends. [4]

With the demise of the Foreign Sales Corporation, Congress acted quickly to provide a new incentive for export sales – the Extraterritorial Income (ETI) exclusion, enacted in 2000. This legislation simplified the requirements under FSC and expanded eligibility for benefits. The ETI legislation allowed

individuals, S corporations, partnerships, U. S. companies with net operating losses or in an alternative minimum tax position to benefit from the legislation. [13] The amount of tax savings was the same as under the FSC regime, but the cost to the government was larger due to a wider range of included entities. [23]

The ETI did not require the establishment of a separate entity, as under the FSC. Taxpayers merely needed to satisfy the foreign economic presence test by soliciting, negotiating, or making contracts with respect to export sales transactions outside the United States. Certain costs, such as advertising and transportation must also be incurred outside the United States. [13] Under ETI rules, goods may be manufactured outside the United States, provided that 50 percent or less of the value was attributable to articles manufactured and produced or grown outside the U. S. It also allowed foreign corporations to elect to be treated as domestic corporations and become eligible for ETI benefits. [13] It is apparent that this legislation was an attempt to streamline the old FSC process and, at the same time open the eligibility for the tax benefit to a broader constituency and, in the process, satisfy the rules of the WTO.

However, it was not to be. The ETI legislation took effect in October, 2000 and in January, 2002, the EU challenged the ETI regime and a WTO appellate body ruled that the ETI constituted a prohibited export subsidy. Furthermore, in August of that year the WTO ruled that if the United States did not come into compliance with the appellate decision, the EU could impose more than \$4 billion in sanctions against U. S. products. [21] Apparently, the WTO was tiring of the U. S. offering different versions of illegal export subsidies. Subsequently, the ETI provisions were repealed for transactions after 2004, subject to a transition rule which allowed some ETI exclusions into 2005 and 2006. [20]

INTEREST CHARGE – DOMESTIC INTERNATIONAL SALES CORPORATION

With the Domestic International Sales Corporation being found in violation of GATT rules, a modified version of the DISC was enacted by Congress in 1984. DISC became IC-DISC, Interest Charge - Domestic International Sales Corporation. [7] Even though the name was similar, the structure of the two laws was considerably different. The focus of IC-DISC is for smaller companies, creating a deferral for profits on the first \$10,000,000 in export sales. [14]

An IC-DISC begins when an S Corporation or partnership in the United States forms a subsidiary corporation and applies for tax exempt status as an IC-DISC. The parent then pays a commission for export sales to the IC-DISC, deducting the commission from ordinary income. This saves the parent up to 35 percent in taxes on the commission amount. As the IC-DISC is a tax-exempt entity, it pays no tax on the commission received. The IC-DISC then pays a dividend to the parent, which passes the dividend on to the shareholders or owners. Cash is actually transferred to the IC-DISC, but the subsidiary is not required to perform any services. [5]

The “interest charge” portion of this scheme comes into play if the IC-DISC does not pay out the dividend. In this case, the shareholders are required to pay interest to the IRS on the accumulated but untaxed income. The interest rate paid to the IRS is the base period T-bill rate [7], which can be a very favorable rate. There is also a great deal of flexibility built into the operational rules for these corporations, as the IC-DISC may lend funds back to the parent company in exchange for an interest-bearing note. This helps mitigate any cash drain caused by paying the commission. [16]

When IC-DISCs were first formed, they did not offer much potential for tax savings. Other export incentives were more beneficial. This is evidenced by the fact that only 727 IC-DISC returns were filed in 2000, 16 years after they were made a part of the tax code. [9] This is understandable, as the owner/shareholders would pay tax as high as 35 percent, giving little or no opportunity for tax savings, only a deferment of taxes payable. That changed with The Jobs and Growth Tax Relief Reconciliation Act of 2003. That act created a reduced tax rate for qualified dividends, tied to the capital gains rate. Overnight, the IC-DISC became a very effective tax strategy for exporters. Paying a commission to the IC-DISC enabled the parent to avoid tax at a maximum 35 percent, convert the commission to a qualified dividend with a 15 percent rate and save 20 percent in the process. [14]

The IC-DISC concept has been held to be valid by the World Trade Organization on two different occasions. [25] However, this concept has limited applicability and remains a little-used tax strategy.

THE DOMESTIC PRODUCTION ACTIVITIES DEDUCTION

Between 1971 and 2004 the United States lost the Domestic International Sales Corporation, the Foreign Sales Corporation, and the Extraterritorial Income Exclusion due to challenges from other nations. Faced with international concerns over U. S. tax treatment of exports along with a need to create new jobs in the United States, the Domestic Production Activities Deduction (PAD) was established as a part of the American Jobs Creation Act of 2004. As a part of this act, the ETI was repealed. [8] Rather than create an incentive for exported goods, the PAD created an incentive for companies to produce domestically with the anticipation that increased domestic production would lead to increases in exports.

The basics of the Production Activities Deduction are that businesses with “qualified production activities” can take a tax deduction of three to nine percent of qualified production activity income (QPAI) from net income. One commentator stated that this is a “tax break, pure and simple.” [15] There is not much argument that it is a pure tax break, however it is anything but simple. This is a complicated piece of legislation. This is to be expected when income from one type of activity is singled out for special treatment. In this case the problems are compounded, as income from selected activities, related deductions, and related wages must be isolated. In addition there are rules regarding pass-through entities, related taxpayers, and groups that have foreign and domestic components. It is easy to conclude that the PAD is an administrative nightmare, adding much complexity to the income tax system. It creates problems not only for the taxpayer in attempting to comply, but for the IRS in monitoring that the proper deduction is taken. [24]

Companies not already utilizing cost accounting may be forced to adopt a cost accounting system in order to take advantage of the PAD, and comply with its complex set of rules. It is a deduction that an eligible company should not overlook. It has been described as a “gimmie” deduction requiring no special expenditures [11], a significant tax benefit for a wide range of taxpayers [24], and a deduction that “every small business in the manufacturing sector should be looking at.” [15]

WHO IS ELIGIBLE TO TAKE THE PAD?

Taxpayers eligible to take the Production Activities Deduction are broadly defined. Even though this tax benefit was created out of the ashes of the ETI, it is not limited to companies who export. Also, unlike many of the export-incentive predecessors, the type of organization that may take the PAD is

virtually unlimited. The deduction is available to individuals, C corporations, farming cooperatives, estates, and trusts. In addition, the deduction may be passed through from estates and trusts to their beneficiaries and farming cooperatives may pass it through to their patrons. Although partnerships and S corporations cannot take the deduction, it may be passed through to shareholders and partners. [3]

With seemingly no limit on the type of organization that may take advantage of the PAD, the next question must be “What constitutes ‘domestic production activities?’” This is where application of the deduction starts to get complicated. The Department of the Treasury stated that the following are qualified production activities:

- The manufacture, production, growth, or extraction in whole or significant part in the United States of tangible personal property (e.g., clothing, goods, and food), software development, or music recordings;
- Film production (with exclusions provided in the statute), provided at least 50 percent of the total compensation relating to the production of the film is compensation for specified production services performed in the United States;
- Production of electricity, natural gas, or water in the United States;
- Construction or substantial renovation of real property in the United States including residential and commercial buildings and infrastructure such as roads, power lines, water systems, and communications facilities; or
- Engineering and architectural services performed in the United States and relating to construction of real property. [6]

An item will qualify if it is manufactured in whole or substantial part in the United States. This begs the question, “What is a ‘substantial part?’” The law provides a 20 percent safe harbor. An item will qualify if 20 percent of the cost of goods sold for that item are costs incurred in the United States. The full sales price is then considered domestic production gross receipts. The domestic production requirement must be applied to each item, the company cannot state that 20 percent of their cost of goods sold is U.S.-based and claim that 100 percent of their activities are domestic production activities. [11]

In the event the item does not qualify, the law allows the company to “shrinkback” the item to its largest qualifying component. This is known as the “shoelace rule.” For example, if the company imports a pair of shoes and adds a U. S. shoelace, the sales price attributable to the shoelace qualifies. [11] This will require good record-keeping and the application of a rational allocation base.

HOW IS THE DEDUCTION DETERMINED?

Having determined what constitutes qualified production activities, the company must then convert those activities to dollars, known as domestic production gross receipts (DPGR). This is simply all income arising from qualified production activities. The next step is somewhat more complex as the company must determine the expenses related to that income. By definition, qualified production activity expenses are all expenses directly related to the qualified production activities. If a company has multiple lines of business, this requires an allocation – another task for the cost accountant. [15] The end result is that qualified production activity income (QPAI) is defined as DPGR minus cost of goods sold allocable to these gross receipt minus other direct costs allocable to these receipts minus a ratable portion of indirect costs allocable to DPGR. [22]

The Production Activities Deduction is currently equal to six percent of the company's QPAI. In 2005 and 2006, this percentage was three percent, and is scheduled to increase to nine percent for tax years beginning after December 31, 2010. [10] There are two limitations placed on this deduction. The deduction may not exceed adjusted gross income (for sole proprietor, partnerships, S-corporations or LLCs) or taxable income for C corporations. Additionally, the deduction may not exceed 50 percent of W-2 wages paid. [15] This latter limitation is the portion of Section 199 that is targeted toward job creation.

SURVEYING THE IC-DISC AND THE PAD

A survey was undertaken to determine awareness of accounting professionals in regard to the Interest Charge – Domestic International Sales Corporations and of the Production Activities Deduction. Respondents were asked to indicate their level of knowledge of these two statutes on a six-point scale from “excellent” to “no experience.” The survey was distributed to an online discussion group, the IMA Financial Management Email Exchange. In addition, it was distributed at a meeting of the Polk County Florida Institute of CPAs and to an accounting CPE seminar held at Florida Southern College.

Eighty-one responses were received. Of these, 67 hold some type of professional certification and 59 were CPAs. Forty-seven are employed in CPA firms and eight are in manufacturing. Forty-seven respondents indicated some paid income tax preparation activity, including 26 who prepare over 100 returns annually.

The following summarizes responses to the question “How would you rate your level of knowledge of the Domestic Production Activities Deduction?”

Excellent	2
Very Good	3
Good	15
Fair	13
Poor	14
No Experience	34

Responses to the question, “How would you rate your level of knowledge of the Interest Charge-Domestic International Sales Corporation (IC-DISC)?” were as follows:

Excellent	0
Very Good	0
Good	0
Fair	7
Poor	20
No Experience	54

This survey indicates that many do not understand the Production Activities Deduction, with 75.3 percent indicating a fair understanding or less. The survey indicates an even lesser awareness and understanding of the IC-DISC, with all respondents indicating a fair understanding or less of the IC-DISC.

A majority of respondents (55) are involved in the manufacturing function or as tax return preparers. These are the individuals who should know about this legislation. One comment by a CPA preparing 201-500 returns annually stated “This is the first time I have ever heard about these.” Another stated, “PAD is a pain to calculate!” Two manufacturing CFO’s indicated a lack of awareness of these tax benefits. It is understandable that someone not involved in export activity would not know about the IC-DISC. However, since the PAD is available to so many taxpayers, anyone in manufacturing can potentially benefit from it. Preparers are not helping their clients minimize their tax liability if they do not consider the PAD for their clients.

ANALYZING THE PRODUCTION ACTIVITIES DEDUCTION AS TAX POLICY

There is no agreement on what constitutes good tax policy. In his 1776 classic, *The Wealth of Nations*, Adam Smith set forth four principles that he said should guide the making of tax policy. These principles serve as the foundation of today’s concepts of what principles should guide our tax policy decisions. These principles bear repeating here:

- The subjects of every State ought to contribute toward the support of the Government as nearly as possible in proportion to their respective abilities.
- The tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor and to every other person.
- Every tax ought to be so levied as the time or in the manner in which it is most likely to be convenient for the contributor to pay it.
- Every tax ought to be so contrived as both to take out and keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the State. [19]

In today’s terminology, we would place these into the broad objectives of Equity, Simplicity, and Efficiency. [19] The AICPA, the Tax Foundation, the Organisation for Economic Co-operation and Development, and universaltax.com have all set forth their lists of good tax policy. Numerous individuals have also contributed their views on good tax policy. [17]

The Production Activities Deduction and the Interest Charge – Domestic International Sales Corporation will be evaluated in view of Adam Smith’s principles, breaking equity into the two components of horizontal and vertical equity.

Horizontal equity, according to Eugene Steuerle, is almost universally accepted as a principal. By horizontal equity, Steuerle asserts that those with equal ability pay equal taxes. Even when one group is favored by tax legislation, horizontal equity is achieved internally within that group. As an example, if the law allows a deduction for charitable contributions, the group making such contributions is the favored group, receiving specialized treatment compared to other taxpayers. However, horizontal equity is applied internally to those with the group, allowing a charitable contribution for all who make such contributions. [18] Since the Production Activities Deduction applies to any company with defined domestic production activities, horizontal equity is present in this legislation.

IC-DISCs do not measure up in regard to horizontal equity. Unlike the PAD, it is not available to as many types of organizations. Additionally, it is limited to companies with profits of \$10,000,000 or

less. As the IC-DISC is an export incentive and all exporters are not eligible for this tax benefit, horizontal equity is not present as all exporters are not eligible for the IC-DISC.

Vertical equity is the principle that those with greater ability to pay should pay more in taxes. This is reflected in our income tax system of progressively higher marginal tax brackets as income increases. It is argued that this is a desirable principle, as those in lower economic straits cannot afford to pay an equal share for the support of the government. Vertical equity, then, is a function of how progressive the tax rates are. [18]

The PAD is not progressive as the amount of the deduction is the same percentage for all. However, the amount of the deduction is limited by taxable income and W-2 wages. The effect is that the greater one's income level, the greater amount of potential deduction. Vertical equity is achieved in the Production Activities Deduction.

The IC-DISC can reduce the tax liability from export sales to as low as 15 percent. The greater the income (up to the statutory limits), the greater the savings in dollars and as a percentage. Vertical equity is present in the IC-DISC.

In its "Ten Guiding Principles of Good Tax Policy," the AICPA states that tax law should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner. [2] The Production Activities Deduction does not achieve simplicity. It has already been observed that a company with more than one line of business will need to utilize a cost accounting system in order to properly allocate costs between revenues generated as qualified production activities and those that do not qualify. In addition, several observers have commented on the complexity of this law.

The implications of the survey are substantial. If taxpayers do not understand a piece of tax legislation that will lower their tax liability, they will fail to take advantage of it. As one writer stated, "Many practitioners weren't convinced the Sec. 199 deduction was applicable or cost-effective for their clients. Consequently, many practitioners failed to evaluate the applicability of the deduction to their clients." [24] The fact that practitioners failed to evaluate the applicability indicates a level of complexity that should not exist. However, the second part of this statement is even more troubling. That a significant tax break is available to taxpayers is so complex that it is not cost effective to take that deduction carries two implications. First, this violates the cost-benefit principle that the benefits to be derived from an action should exceed the cost of taking that action. In avoiding the PAD, companies are seemingly taking the rational approach in applying the cost-benefit principle. Whether this is a correct approach is beyond the scope of this paper, but deserves consideration. The second implication is that when taxpayers do not take the deduction, the law is not achieving its intended purpose of encouraging domestic production and the creation of new jobs. In this respect both the Production Activities Deduction and the Interest Charge – Domestic International Sales Corporations must be judged a failure. They are not simple provisions in the tax code.

The final principle of tax policy is that of efficiency. Efficiency suggests that programs should not operate in a way that makes someone better off at the expense of making someone else worse off. This is a situation that can rarely be achieved in the tax policy arena. However, tax policy must seek to produce gains in the overall economic output even at the expense of losses to some individuals. Since by their very nature, taxes distort behavior, efficiency is lost as this change in behavior increases. Therefore,

the principle of efficiency should seek to minimize these changes, not eliminate them. Taken a step further, it is stated that the changes in behavior that occur should be justified by gains from the programs the taxes support. [18] Given that those taking the deduction are encouraged to increase domestic production activities and to increase employment, it can be argued that the Production Activities Deduction meets the efficiency criteria. However, due to the lack of simplicity in the Section 199, it becomes apparent that it is not an efficient piece of legislation. If the process of determining the eligible deduction were simplified, more benefit would apparently be realized from this legislation.

For the IC – DISC, there are significant changes in behavior as a separate corporate structure must be formed and maintained. The steps that must be taken in order to comply with the IC-DISC requirements are ones that require planning, and significant changes in behavior. From a macro view, given the limited use of the IC-DISC, one can conclude that the costs involved exceed the benefits to society. Efficiency is not an element of this tax legislation.

SUMMARY AND CONCLUSION

Both the IC-DISC and the PAD do not meet the principles of good tax policy. The Interest Charge-Domestic International Sales Corporation meets only the principle of vertical equity. The Production Activities Deduction meets the principles of horizontal and vertical equity. Both acts fail miserably in regard to simplicity and efficiency.

Three observations can be made from this paper. First, with the introduction of the Production Activities Deduction, it appears that the United States has abandoned any attempt to achieve a tax preference for export activity. After the Domestic International Sales Corporation, the Foreign Sales Corporation, and the Extraterritorial Income Exclusion were determined to be in violation of international agreements, the PAD represents a different approach that may help achieve the same objective.

Second, the Interest Charge – Domestic International Sales Corporation has been upheld as not in violation of any international agreements. However, it continues to be an under-utilized section of the Tax Code. One can speculate as to the reasons, but it seems likely that it has not received more widespread adoption due to the procedures that must be followed in order to comply with this section of the tax code. Exporters who are aware of its existence likely feel that the costs of complying with this act are not worth the benefits received. Additionally, one should note that this is available to “small” corporations – those not as likely to have the tax expertise and ability to easily comply with the requirements of the IC-DISC.

Third, the Production Activities Deduction is a very lucrative deduction. As has already been observed, this deduction is a “gimmie,” a company does not have to spend any money to take this deduction – just take a percentage of domestic production activity income. However, determining the base on which to take that percentage deduction is the catch in this legislation. The PAD is a very complicated piece of legislation and many companies and practitioners simply do not bother with it. This raises the issue of tax complexity. Our tax code should not be so complex that taxpayers do not take advantage of a tax break simply because it is too complex to determine the amount of the benefit. There are two sides to this complexity. In addition to it being difficult for taxpayers to compute the correct amount of the deduction, it is equally difficult for the IRS to determine if a taxpayer has properly

complied with this portion of the tax code. Future legislation should make the tax policy principle of simplicity a priority.

APPENDIX

Income Tax Export Incentives - PAD and IC-DISC

In the past 40 years, the Income Tax Code has included a number of incentives to boost export activities. After several of these were struck down by the World Trade Organization the U. S. ended up with two - the Interest Charge - Domestic International Sales Corporation and the Domestic Production Activities Deduction. I appreciate your input on this short survey to determine your level of familiarity with these tax provisions. This is for research purposes and your response will remain totally anonymous.

1) How would you rate your level of knowledge of the Domestic Production Activities Deduction?

- Excellent
- Very Good
- Good
- Fair
- Poor
- No Experience

2) How would you rate your level of knowledge of the Interest Charge - Domestic International Sales Corporation (IC-DISC)?

- Excellent
- Very Good
- Good
- Fair
- Poor
- No Experience

3) How many income tax returns do you prepare annually as a paid preparer?

- Zero
- 1-25
- 26-100
- 101-200
- 201-500
- 500 or more

4) What professional certifications do you hold? Check all that apply.

- CPA
 - CMA
 - CIA
 - Enrolled Agent
 - None
 - Other, please indicate what additional certifications you hold
-

5) In what industry are you employed?

- CPA firm
- Non-CPA Accounting Firm
- Manufacturing
- Retail
- Other service
- Government

6) Please include any comments you may have about the Domestic Production Activities Deduction or Interest Charge - Domestic International Sales Corporations.

Thank you for your input. If you have any additional comments or questions feel free to contact me at jstancil@verizon.net

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