Taxing Decisions

Gary S. Wolfe and Ryan Losi

International Tax Evasion And Money Laundering
International Tax Planning For U.S. Exports (IC-DISC)

International Tax Evasion And Money Laundering — ***by Gary S. Wolfe***

International tax evasion has been the "Sport of Kings" for centuries. Cloaked in secrecy, done surreptitiously, no one could ever prove it. The "Super-rich" (i.e., the top one percent) get away with it and used their "tax cheating proceeds" to buy assets; e.g., real estate, boats, planes, cars, diamonds and art (all of which may constitute "money laundering").

The willful tax cheating by the super-rich may be "tax treason" defined: the betrayal of a trust, treachery; the offense of attempting by overt acts to overthrow the government of the state to which the offender owes allegiance.

So why do tax cheats get away with treason? Why do governments all over the world let the richest people cheat on their taxes and commit tax treason? What is the bottom line to tax treason? Is it that billions of people around the world suffer and live without adequate nutrition, housing, clothing, health care and education? Who is responsible for this tax mess?

With the proliferation of the Internet as an information database, after centuries of secrecy, the truth is coming out. Transparency is coming of age, and for the super-rich tax cheats, their days appear numbered.

Consider Recent Events In Spain And Africa

In Spain, there are 1,600 cases involving embezzlement, tax evasion, kickbacks, and Swiss bank accounts, including the former treasurer of Spain's ruling party, who was indicted and the former head of the country's Supreme Court, who resigned in

Gary S. Wolfe has been in private practice in Los Angeles, Beverly Hills (and Century City) since 1982. He is an international tax lawyer representing clients for IRS audits, international tax planning, and asset protection. Previously, Gary was the managing partner of a tax and business law firm which represented Fortune 500 companies (IBM, ITT) and financial institutions (Sterling Bank, First Charter Bank.) Gary now provides case management for international litigation. Since 2004, Gary has been conducting private seminars throughout California on international tax and asset protection. He can be reached at gsw@gswlaw.com. Gary's co-author on International Tax Planning For U.S. Exports (IC-DISC) is **Ryan Losi,** CPA. Ryan is Executive Vice President of PIASCIK, in Glen Allen, Virginia, and leads the firm's business development efforts. He has presented at numerous organizations and universities, including U.S. Export-Import Bank, Virginia Conference on World Trade, South Carolina International Trade Conference, Council for International Tax Executives, Medical Society of Virginia, James Madison University, Virginia State University, Virginia Economic Development Partnership and many others. He has vast domestic and international work experience in the technology and manufacturing sectors after tenures at PricewaterhouseCoopers, as an International Manager in their New York, New York office and at KPMG in the Richmond, Virginia office where he served in both their International and Domestic Tax Practices. He can be reached at rlosi@piascik.com.

disgrace. And now, Spain's Princess, Cristina, could land in jail and topple King Juan Carlos and the Spanish monarchy.

In April 2013, Princess Cristina was indicted on charges of complicity in fraud, tax evasion, money laundering and embezzlement, the first member of a European royal family to be charged in a serious crime in centuries.

The case revolves around her husband, Duke of Palma, Inaki Urdangarin, who is accused of fraud, tax evasion, forgery and the embezzlement of $7.8 million from regional governments through inflated contracts via their non-profit organization, Institute Noor.

Judge Jose Castro oversaw the Princess' indictment, saying she gave her consent to her husband's "shady deals." A specially appointed anti-corruption prosecutor requested the indictments be dropped. On May 7, 2013 an appeals court ruled to dismiss the case in a preliminary judgment. Judge Castro is likely to pursue another indictment.

In Africa, on May 10, 2013, a 120-page Africa Progress Report was issued, stating that $63 billion is lost annually in Africa through tax evasion, corruption, and secret business deals — more than all the money coming into Africa through aid and investment. Despite Africa's surging economic growth, fueled by a global resources boom, poverty and inequality have worsened.

Kofi Annan, the former U.N. Secretary General, who heads the panel that wrote the report, stated that "[i]t is unconscionable that some companies, often supported by dishonest officials, are using unethical tax avoidance, transfer pricing, and anonymous company ownership to maximize their profits while millions of Africans go without adequate nutrition, health and education." The report stated:

"Revenues that could have been used to impact lives have instead been used to build personal fortunes, finance civil wars and support corrupt and unaccountable political elites. Revenue losses on this scale cause immense damage to public finance and to national efforts to reduce poverty. Some political elites continue to seize and squander the revenues generated by natural resources, purchasing mansions in Europe or the U.S. or building private wealth at public expense."

In the U.S., tax evasion is a felony (under Internal Revenue ("Code") Code section 7201) with a penalty of up to five years in prison. In addition, the crime of tax evasion includes other crimes for which a U.S. taxpayer may be prosecuted, including:

- Obstructing tax collection. Under Code section 7212, a penalty of up to three years in prison;
- Conspiracy to impede tax collection. Under 18 U.S.C. §371, a "Klein Conspiracy," in which two or more persons agree to impede IRS tax collection, a penalty of up to five years in prison;
- Filing a False Tax Return: Under Code section 7206(1), up to three years in prison;
- "FBAR" violation. Willful violation re: disclosing foreign aggregate accounts over $100,000, up to 10 years in jail. 31 U.S.C. §5322(b).

If federal prosecutors throw the book at tax cheats, they may face over 25 years in prison.

Tax evasion by itself is punishable by over 25 years in prison. In addition, separate crimes may include money laundering, wire fraud, and mail fraud (each of which are separate felonies punishable by 20 years plus, in prison). So if a tax cheat commits tax evasion, money laundering, wire fraud, and mail fraud, the maximum penalties may be over 85 years in prison (with an additional 10 years if the violation affects a financial institution).

For U.S. persons who are involved with international tax evasion (i.e., they collaborate with tax cheats from other countries helping those international tax cheats commit tax evasion and launder money), they may be held liable for money laundering, a separate offense, since foreign tax evasion is a predicate offense, a Specified Unlawful Activity ("SUA"); i.e., a foreign crime, which subjects the U.S. person to penalties for money laundering.

In the *Pasquantino* case, 544 U.S. 349 (2005), the U.S. Supreme Court determined that a foreign government (i.e., Canada) has a valuable property right in collecting taxes (in *Pasquantino,* "excise taxes"), The Supreme Court held that international tax evasion (i.e. taxes due to a foreign government) is an SUA, which is both a predicate offense for money laundering (it is a foreign crime), and is a violation of the wire fraud statute (18 U.S.C. §1343) (i.e., the uncollected Canadian excises were "property" for purposes of the fraud element in the wire fraud statute). In *Pasquantino,* the U.S. Supreme Court held that the defendant's failure to pay taxes inflicted economic injury on Canada "no less than had they embezzled funds from the Canadian treasury." the defendants used interstate wires to execute a scheme to defraud a foreign sovereign of tax revenues. Their offense was complete the moment they executed the scheme inside the U.S., the wire fraud statute punishes the scheme, not its success.

International tax and estate planning may lead to tax evasion (and additional crimes, such as money laundering, mail fraud, and wire fraud) if the U.S. taxpayer either fails to pay tax due to federal, state, or foreign governments. The U.S. taxpayer may be culpable for violation of U.S. wire fraud laws, money laundering laws or mail fraud laws, which may lead to asset forfeiture.

Money laundering is the disguise of the nature or the origin of funds. It includes the transmutation of tax evasion proceeds into personal assets or third-party distributions (to family, friends, and others).

Income tax deficiencies (i.e. failure to pay tax due) which create "tax cheating" proceeds, when used to purchase assets or make investments may subject the taxpayer to separate felonies:

- Tax evasion (failure to pay the tax due);
- Money laundering. The use of proceeds from a specified unlawful activity, i.e., tax evasion, to purchase or make investments in assets which transmute the original illegal tax-cheating proceeds into another asset;
- Mail fraud. The use of the postal system to effectuate a scheme to defraud. 18 U.S.C. §1341;
- Wire fraud The use of the telecommunications facilities to effectuate a scheme to defraud. 18 U.S.C. §1341.

Money Laundering

Money laundering may be linked to tax evasion. A violation of the money laundering statutes includes a financial transaction involving the proceeds of an SUA with the intent to:

- Promote that activity;
- Violate Code section 7201 (which criminalizes willful attempts to evade tax); or
- Violate Code section 7206 (which criminalizes false and fraudulent statements made to the IRS).

The tax involved in the transaction (and which is avoided) may be any tax: i.e. income, employment, estate, gift and excise taxes. See U.S. Dep't. of Justice, Criminal Tax Manual, Chapter 25, 25.03(2)(a).

Under the money laundering statutes, the IRS is authorized to assess a penalty in an amount equal to the greater of the financial proceeds received from the fraudulent activity or $10,000 (under 18 U.S.C. §1956(b)), the authority is granted by statute to the United States not the IRS, and is enforced either by a civil penalty or a civil lawsuit.

Violations of statutes for mail fraud, wire fraud, and money laundering are punishable by monetary penalties, as well as civil and criminal forfeiture. (See 18 U.S.C. section 981(a)(1)(A) which permits property involved in a transaction that violates 18 U.S.C. sections 1956, 1957, and 1960 to be civilly forfeited).

Civil forfeiture statutes include:

- 18 U.S.C. section 1956, which outlaws the knowing and intentional transportation or transfer of monetary funds derived from specified criminal offenses. For section 1956 violations, there must be an element of promotion, concealment, or tax evasion;
- 18 U.S.C. section 1957, which penalizes spending transactions when the funds are contaminated by a criminal enterprise;
- 18 U.S.C. section 1960, which penalizes the unlicensed money transmitting business.

Under 18 U.S.C. section 981(b)(2), seizures are made by warrant in the same manner as search warrants. Under 18 U.S.C. section 981(b)(1), the burden of proof is by a preponderance of the evidence. The property may be seized under the authority of the Secretary of the Treasury when a tax crime is involved.

Under 18 U.S.C. section 982(a)(1), if the offense charged is a violation of the Money Laundering Control Act, and the underlying specified unlawful activity is mail or wire fraud, courts may order criminal forfeiture of funds involved in the activity on conviction.

The U.S. Department of Justice Tax Division policy requires U.S. attorneys to obtain Tax Division approval before bringing any and all criminal charges against a taxpayer involving a violation of the Code. Absent specific approval, additional criminal charges for wire fraud, mail fraud and money laundering would not normally be included. See U.S. Dept. of Justice Criminal Tax Manual, Chapter 25, 25.01. If the additional criminal charges are approved, the taxpayer risks having the trust assets seized or forfeited.

Regarding asset seizure, the U.S. government may seize assets pursuant to a violation of the money laundering laws. In addition, the IRS has authority for seizure and forfeiture under Title 26. Under Code section 7321, any property that is subject to forfeiture under any provision of Title 26 may be seized by the IRS.

Code section 7301 allows for the IRS to seize property that was removed in fraud of the Internal Revenue laws. Code section 7302 allows the IRS to seize property that was used in violation of the Internal Revenue laws.

In the case of transfer of funds to an offshore trust, it can trigger a violation of U.S. money laundering laws and lead to asset forfeiture. For example, tax counsel may recommend a tax planning strategy, and provide instructions by telephone, email or U.S. mail, which include client's transfer of funds pursuant to tax counsel's instructions. These combined actions may trigger a violation of U.S. money laundering laws and lead to asset forfeiture.

Tax Counsel, Tax Evasion (and Money Laundering) Offshore Trusts

A U.S. taxpayer's failure to comply with U.S. tax law may implicate tax counsel in tax evasion. The IRS or the U.S. Dept. of Justice may allege that tax counsel aided and abetted the client in evading U.S. tax, if tax counsel:

- Aided and assisted the U.S. taxpayer in the submission of materially false information to the IRS. Code §7206(2); or
- Assisted the client in removing or concealing assets with intent to defraud. Code §7206(4).

For a U.S. taxpayer's transfer of assets to an offshore trust, despite receiving U.S. tax counsel's tax compliance recommendations, the U.S. taxpayer fails to comply with U.S. tax law, and tax counsel fails to ensure ongoing tax compliance, tax counsel may be implicated in money laundering.

If the U.S. taxpayer's tax noncompliance includes: tax evasion and transfer of the tax evasion proceeds to the offshore trust by wire transfer or U.S. mail, the transfer of funds may be classified by the IRS/U.S. Dept. of Justice as wire fraud or mail fraud, both of which are SUAs under the Money

Laundering Control Act (18 U.S.C. §1956 and 1957), the U.S. taxpayer and their tax counsel may be criminally prosecuted for violation of the money laundering statutes.

Specified Unlawful Activities are listed in 18 U.S.C. section 1956(c)(7). SUAs are the predicate offenses for money laundering and come in three categories:

- State crimes;
- Federal crimes; and
- Foreign crimes.

If the U.S. client transfers funds to an offshore trust under a tax counsel's tax-planning strategy and the U.S. tax client is not in compliance with U.S. tax laws (despite tax counsel's recommendations) then tax counsel may be exposed to IRS penalties:

- Code section 6694 imposes civil penalties on tax preparers;
- Code section 7212: imposes criminal penalties for interfering with the administration of the Internal Revenue laws.

International Tax Planning For U.S Exports (IC-DISC) — *by Gary S. Wolfe and Ryan Losi*

In 2013, after a five-year-plus "Great Recession," America needs jobs — millions of them have been lost since 2007. One solution is to propagate international export of U.S.-made products, which may both accelerate new U.S. hiring and increase U.S. jobs.

Under the Internal Revenue Code, a special type of U.S. corporation, an "IC-DISC" provides significant tax benefits for closely held, small and mid-size U.S. corporations who export U.S.-made products. By use of an IC-DISC, U.S. manufacturers who internationally export U.S.-made products may annually, indefinitely defer tax on $400,000 to $2.5 million of foreign sales revenues.

Under the IC-DISC tax rules, up to $10 million in annual foreign sales is subject to a formula, which limits the tax deferral (i.e., the greater of: four percent of foreign sales (up to $10 million; i.e. $400,000), or 50 percent of net income (on $10 million in foreign sales), which is computed: $10 million less expenses (e.g., $5 million) = $5 million net income x .50 percent = $2.5 million (or more if net income is higher than 50 percent.).

Under the IC-DISC tax rules:

- No corporate income tax (for IC-DISC);
- Indefinite tax deferral (subject to a less than one percent interest charge, annually; i.e., in 2013, 16 basis points (.16 percent), which on $2.5 million is $4,000 per year);
- Reduced tax on distributions (20 percent not 39.6 percent);
- No tax on distributions (with international tax planning).

In addition, the U.S. manufacturer, who exports the U.S.-made products, receives a corporate income tax deduction for the annual IC-DISC "sales commission" paid, (up to $2.5 million per year or more, subject to the 50 percent net income test) which may be worth nearly $1 million annually in tax savings. For example, if the IC-DISC is paid $2.5 million and the U.S. manufacturer pays the top corporate income tax rate (38 percent) = $950,000 corporate tax savings, with no corresponding income declared by the IC-DISC (since their income is indefinitely tax-deferred).

The proposed international tax planning strategy includes an IC-DISC which receives $2.5 million yearly as tax-free income from the export of U.S. made products and with the IC-DISC shares owned and held by a Puerto Rico-issued private placement variable life insurance policy. This policy contains two component parts:

- A "MEC frozen cash value" and a "non-MEC." The annual $2.5 million shareholder distributes trust fund non-MEC (which has tax-free withdrawals of both basis and earnings) and then funds a MEC (which has tax-free withdrawals of basis, with earnings applied to increase the policy death benefit);
- If the IC-DISC distributes $2.5 million per year (over 15 years), total: $37.5 million, the IC-DISC annual distribution requirement will be satisfied and a $37.5 million shareholder dividend may be paid tax-free, plus a tax-free distribution (by loan) of any non-MEC earnings.

In summary, $37.5 million plus tax-free withdrawal of basis, plus investment earnings (tax-free for the non-MEC, MEC earnings apply to insurance policy death benefit (tax-free). Judge Learned Hand, dissenting in *Commissioner v. Newman,* 159 F.2d 848, 850-51 (2d Cir. 1947), stated: "Over and over again courts have said that there is nothing sinister in so arranging one's affairs to keep taxes as low as possible. Everyone does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands...."

Companies that export U.S produced goods may significantly reduce their U.S. taxes by establishing an Interest Charge Domestic International Sales Corporation ("IC-DISC"). Congress encourages the export of U.S produced goods via an export incentive under Code section 991, an "arcane provision" of the Internal Revenue Code. Code section 991 provides a powerful tax incentive to promote the export of U.S produced goods through a Domestic International Sales Corporation, including:

- Lower income tax rate. A 19.6 percent tax rate savings, IC-DISC income is taxed at 20 percent not 39.6 percent (a favorable "tax arbitrage"). Code §1(h)11;
- Tax deferral. For a miniscule annual interest charge of less than 1 percent (computed on the base period T-Bill rate for the period ending September 30, 2012, i.e., 0.16 percent), IC-DISC corporate commission income on the first $10 million of export sales shall not be taxed until an actual distribution is made to shareholders. Based on experience IC-DISC corporate commission income will usually range anywhere from $400K to $2.5 million on the first $10 million of export sales. Until an actual shareholder distribution, the IC-DISC commission income compounds almost "tax free" (i.e., subject to 0.16 percent annual interest charge). The tax deferral is indefinite (i.e., no tax until an actual shareholder distribution). Code §995(f);
- No Corporate Income Tax. An IC-DISC pays no corporate income tax. Code §991.

Since 95 percent of global consumers are international (i.e., outside the U.S.), U.S. exports have a "wide International audience" (See, Bloomberg Business Week 4/1/13). Leading U.S. experts include:

- Information products. Films, sound recordings (i.e., music), and software;
- Entertainment products. Toys, videogames, DVDs, posters, watches, clocks, and jewelry;
- Clothing. Fashion apparel, celebrity merchandising; e.g., T-shirts, jeans, et al.

For exporters of U.S produced goods, the world is a big market.

History Of The IC-DISC

The DISC regime was enacted by Congress to stimulate exports in 1971. U.S. exporters were allowed to avoid U.S. tax on a portion of their profits by allocating those profits to a DISC subsidiary. U.S. trading partners filed complaints with the provisional organization of General Agreement on Tariffs and Trade ("GATT"), now know as WTO, that the DISC regime was an "illegal export subsidy."

Under pressure from GATT, the U.S. Congress then passed the Foreign Sale Corporation ("FSC") regime in 1984, which replaced the DISC regime. The DISC regime was not repealed entirely; it was altered and became the IC-DISC regime.

The IC-DISC regime was unattractive compared to the FSC regime because it provided only a temporary tax benefit (i.e., tax deferral) versus a permanent tax benefit provided under the FSC regime. The FSC regime responded to controversy about the subsidy claims by U.S. trading partners by requiring a U.S. exporter to establish a foreign corporation and that foreign corporation had to perform certain foreign economic processes and activities to obtain the U.S. tax benefit. U.S. trading partners objected to the FSCs as being conduits having no substantial economic substance or purpose other than to subsidize U.S. exporters, and the FSC regime was an "illegal export subsidy."

In response, Congress passed the Extraterritorial Income ("ETI") regime, which replaced the FSC regime and repealed the FSC regime. The ETI regime did not require a separate legal entity but rather excluded a portion of an exporter's income from taxation.

After complaints from the World Trade Organization ("WTO"), Congress then repealed the ETI regime in 2004 over a three year period (2004-2006).

At this time, the IC-DISC became an attractive tax planning vehicle when the 2003 Tax Act ("Jobs and Growth Tax Relief Reconciliation Act of 2003") was enacted and the IC-DISC income was classified under very favorable dividend tax rules (i.e., the IC-DISC income was taxed at the new qualified dividend tax rate (in 2004--15 percent, in 2013--20 percent).

The result of the 2003 Tax Act was that by creating an IC-DISC, exporters of U.S produced goods may obtain a permanent tax savings of up to 50 percent on U.S. income from foreign exports (based on net export income). The tax benefits are also available for companies when products are exported by another party (i.e., reseller/distributor), or "ultimately used" outside the United States.

IC-DISC Tax Strategy

Permanent tax savings start with the U.S. exporting company declaring a tax deduction on the commission it pays to the IC-DISC from its ordinary income, which is taxed at a maximum tax rate of 39.6 percent.

Federal tax law (Code section 994) establishes the commission rate, which is based on export sales revenue (maximum $10 million in annual export sales; i.e., qualified export receipts). The commission rate, which is based on up to $10 million (export sales revenue) is the greater of 50 percent of net export income, or four percent of export sales revenue. Since the IC-DISC is tax-exempt (i.e., no corporate income tax), tax is only paid on distributions to shareholders. The tax is imposed at the tax rate of 20 percent (2013) (i.e., the qualified dividend tax rate), not the current ordinary income tax rate (maximum) of 39.6 percent (2013).

The commission income is tax-deferred while held in the IC-DISC, until distributed to the shareholders. The deferral of U.S. tax on the commission income (for up to $10 million in annual export sales; i.e., qualified export receipts), can be indefinite, is only subject to a minimum interest charge (as previously referenced 0.16 percent (2013), on the deferred tax liability. Code §995(f).

The ultimate tax benefits include:

- The 19.6 percent differential between the qualified dividend tax rates and the ordinary income tax rates;

- An income tax deduction for the exporting company, on the commission paid to the IC-DISC;
- No corporate income tax for the IC-DISC;
- For U.S. exporters who operate their business via a sole proprietorship or pass- through entity (e.g., limited liability company ("LLC"), S-Corporation or limited partnership ("LLP")), the IC-DISC benefit is the difference between the qualified dividend tax rates and the ordinary income tax rates;
- Exporters who operate their businesses via a C-Corporation can benefit by using the IC-DISC to eliminate double taxation on a majority of their export income, as well as to reduce additional payroll taxes on income paid to their shareholders/officers.

IC-DISC Qualification

To qualify an IC-DISC, a domestic corporation must pass two main tests:

- The qualified export receipts test; and
- The qualified export assets test.

Qualified export receipts include gross receipts from the sales or exchange of export property, rents for the use of export property outside the U.S., services related to export sales or rents, engineering or architectural services for projects located outside the U.S. and commissions thereon. Code §993(a). The qualified export assets test requires that 95 percent of the assets of the IC-DISC be qualified export assets (Code section 992(a)(1)(B)), which include accounts receivable, temporary investments, export property, and loans to producers. Code §993(b).

The export property must:

- Be manufactured, produced, grown or extracted in the U.S. by a person other than the IC-DISC;
- Be held primarily for sale, lease or rental for use, consumption or disposition outside the U.S.;
- Have a maximum of 50 percent foreign content. Code §993(b).

IC-DISC Structure

The IC-DISC is a domestic corporation which is a "paper" entity used as a tax-savings vehicle. The IC-DISC does not require office space, employees or tangible assets; instead it is a "conduit" for "export tax savings." IC-DISC shareholders may be: corporations, individuals, limited liability companies, limited partnerships, trusts or estates. The IC-DISC structure is as follows:

- The owners of the U.S. exporting company form a special U.S. corporation that elects to be an IC-DISC. The IC-DISC election is made on IRS Form 4876-A. The IRS Form 4876-A must be filed within 90 days after the beginning of the tax year. For any tax year that is not the corporation's first tax year, the election must be made during the 90-day period immediately preceding the first day of that tax year;
- The U.S. exporting company pays the IC-DISC a commission;
- The U.S. exporting company deducts the commission from ordinary income taxed at up to 38 percent (top federal tax rate — $15 million-$18.33 million);
- IC-DISC pays no tax on the commission as long as the qualification standards are met: the 95 percent qualified export assets, and the 95 percent qualified export receipts (Code section 992(a)(1). The U.S. exporter qualified export receipts in excess of $10 million per year are not eligible for deferral of tax. Code §995(b)(1)(E);
- IC-DISC shareholders are not taxed until the earnings are distributed as dividends. The shareholders must pay annual interest on the tax deferred (IRC Sec. 995(f)(1)). The interest charge is computed on IRS Form 8404. Shareholders that are individuals (or pass-through entities) pay income tax on qualified dividends at the capital gains rate of 20 percent. Corporate

shareholders are automatically considered to have received 1/17th of the IC-DISC's taxable income even if no distributions are made;
- Foreign persons may receive a larger benefit than U.S. persons if their country of tax residence has a tax treaty with the U.S. that was ratified after 1984.

Additionally, three tests must be passed:
- Content test. Qualifying Foreign Trading Gross Receipts (i.e. export sale) includes property manufactured or produced within the U.S. or held for use or disposition outside the U.S. Foreign content (i.e. cost based on import value) cannot exceed 50 percent of Fair Market Value (i.e., sales price). Content can include related and subsidiary services as well as engineering and architectural services;
- Production test. property is considered manufactured or produced if it is "physically manufactured," that is, it is substantially transformed prior to the sale, or the process to convert is substantial in nature and considered within the industry to be manufacturing or production, or if conversion costs (i.e., direct labor and factory burden) account for 20 percent or more of the total cost of goods sold; and
- Destination test. The property's use or disposition must be outside the U.S., delivery must be made by a seller in the U.S. to a carrier or freight forwarder for ultimate delivery outside the U.S. Delivery must be made to a purchaser in the U.S. if the property is ultimately delivered outside the U.S. within one year of sale ("One Year Rule"). Delivery can also be to another U.S. entity that incorporates product into product used/sold outside the U.S.

Investment Tax Planning

If the U.S. taxpayer's shares in the IC-DISC are owned and held by a Puerto Rico-issued private placement variable life insurance policy then:

- Under Code section 72(e)(5), income from assets (i.e., IC-DISC) are not subject to income tax, nor is there tax reporting. Effectively, the IC-DISC taxable income received by the U.S. taxpayer shareholder is not subject to U.S. income tax or tax reporting;
- Policy lifetime withdrawals may be tax-free and not subject to tax reporting (as either a return of premium/basis or a loan). The MEC rules may or may not apply depending on policy design. IRS Private Letter Ruling 200244001 (May 2, 2002). IRS audit risks are minimized since assets held under a qualifying life insurance policy are neither subject to investor income tax, nor is there any required income tax reporting. Code §72(e)(5), reference: Rev. Rul. 81-225, 1981-2 C.B. 12 (Situation #5), Rev. Rul. 82-54, 1982-1 C.B.11;
- For IRS audit purposes, there would be no presumed IRS tax avoidance, due to the fact that life insurance has been granted an "angel exception" (i.e. is an IRS approved transaction) (IRS Revenue Procedures 2007-20, 2013-11, 2004-67, 2004-68);
- As a U.S. territory, Puerto Rico life insurance policies do not require filing of "FBAR" Form TD F 90-22.1 (Report of Foreign Bank and Financial Accounts), for accounts over $10,000).

Regarding IRS Form 8938, Statement of Specified Foreign Financial Assets for specified foreign financial assets (over $50,000), if the policy is owned by a U.S. limited liability company, Form 8938 is not required to be filed (only applies to individuals), (See IRS Form 8938 instructions, p. 2).

Effectively, all IC-DISC shareholder distributions may be U.S. income tax free, not subject to tax reporting, if the U.S. taxpayer's IC-DISC shares are owned by the U.S. taxpayers Puerto Rico life insurance policy.

Asset Protection

Under Puerto Rico law, the cash value benefits of a life insurance policy are expressly exempt from seizure by creditors (absent fraudulent conveyance funding of the policy). Act No. 399 of September 22, 2004, as amended by Act No. 98 of June 20, 2011. Under Act No. 98 (June 20, 2011), which amended Act. No. 399 (September 22, 2004), the policy owner and policy beneficiary are statutorily protected from seizure.

Conclusion

The tax strategy for export of U.S-made products includes an IC-DISC owned by a Puerto Rico private placement life insurance policy. The tax planning strategy:

- Reduced tax/tax arbitrage. A lower tax rate on income (in 2013, income is taxed at 20 percent, not 39.6 percent);
- Tax deferral. For an annual interest charge of 0.16 percent (as of 9/30/12) between $400,000-$2.5 million of IC-DISC, corporate income is not taxed until distributed to shareholders, until then income annually compounds tax free (subject to 0.16 percent interest charge);
- No corporate income tax on IC-DISC earnings;
- For IC-DISC shares held by U.S. taxpayers, Puerto Rico Life Insurance Policy, IC-DISC income distributed to shareholders is not subject to U.S. income tax or tax reporting, minimizing IRS tax audit risks;
- In addition, the tax strategy includes asset protection planning for the IC-DISC shares, which are held by the Puerto Rico Life Insurance Policy "cash value" (premiums paid plus earnings) are expressly exempt from creditors, and the policy owner and beneficiary(s) are statutorily protected from seizure.

Based on Ryan Losi, CPA's IC-DISC tax projections, the tax planning strategy has significant income tax benefits:

- The $37.5 million distributions to the Puerto Rico Private Placement Life Insurance Policy (15 years) if invested may grow in value, and with compounded annual tax-free earnings, may be worth (in 15 years) $83,310,954 (if invested in a S&P 500 index fund; the S&P 500 has averaged an annual 10.6 percent return with cumulative dividend, over the last 30 years) or $118,951,027 (if invested in a hedge fund whose annual return are 15 percent, which is the hedge fund annual yearly projected yield);
- U.S. Exporter ("ABC, Inc."): No IC-DISC, $5 million [Annual Net Export Income],
- $2,637,800 [Combined Federal Tax, All Income], $2,362,200 [Net Annual After-Tax Income] x15 years = $35,433,000 [Net Aggregate After-Tax Return];
- U.S. Exporter ("ABC, Inc."): IC-DISC, $5 million [Annual Net Export Income], $1,913,900 [Combined Federal Tax on All Income], $3,086,100 [Net Annual After-Tax Income] x
- 15 years = $46,291,500 [Net Aggregate After-Tax Return];
- U.S. Exporter ("ABC, Inc."): IC-DISC Owned by PPLI, $5 million [Annual Net Export Income], $1,318,900 [Combined Federal Tax on All Income], $3,681,100 [Net Annual After-Tax Income] x 15 years = $55,216,500 [Net Aggregate After-Tax Return];
- The proposed tax planning strategy may save the U.S. client $19,783,500 in income taxes over 15 years (i.e. $55,216,500- $35,433,000];
- If the U.S. client only uses the IC-DISC planning (without the PPLI), they may save $10,858,500 in income taxes over 15 years (i.e. $46,291,500-$35,433,000]. The PPLI saves additional income taxes of up to $8,925,000.