SHEPARD SCHWARTZ & HARRIS LLP

Business Advisors For Privately Owned Companies

TAX BRIEFS

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Tax Savings Still Available for Exporters Using an IC-DISC

Over the years, Congress has always passed legislation giving U.S. companies incentives to export U.S. produced goods in order to become more competitive globally. The last remaining export incentive available today is the Interest-Charge Domestic International Sales Corporation, better known as the IC-DISC. Utilizing an IC-DISC can permanently save qualifying U.S. exporters tax up to 20%.

So, how does this work? The exporter sells goods (or certain services) to purchasers in foreign countries. It pays a commission, which is computed according to statute (but is at least 50% of the net export income on export sales of up to $10 million), to a newly-formed IC-DISC. The IC-DISC is generally owned by the same ownership group (directly or indirectly) that owns the exporting company. The payment of the commission is treated as an ordinary business deduction, which reduces the exporter's taxable ordinary income. Ordinary income is taxed at rates up to 35%. The IC-DISC receives the payment as taxable income; however, the IC-DISC is a tax-free entity. The IC-DISC then pays the net (commission) income out to its shareholders in the form of a dividend. The dividend receipt is taxed as a qualified dividend to the shareholder, which is currently subject to a maximum tax rate of 15%. Thus, the exporter has a tax savings of 20%.

This tax benefit is potentially available to any type of entity including partnerships, LLC's, regular corporations and S corporations. To qualify, the entity must either directly export goods it manufactures or manufacture a good that is included in another product that is exported.

Using a simplified example, assume exporter has gross export sales of $8 million, cost of export goods sold of $5 million, and general and administrative expenses allocated to the export sales of $2 million resulting in $1 million of net export income. The exporter would pay the IC-DISC a commission of one-half of the net export income or $500,000. Exporter's income is reduced by $500,000 saving exporter $175,000 (assuming exporter is in the top marginal tax rate of 35%). The commission is not subject to income tax at the IC-DISC level since it is a tax-free entity. The IC-DISC would then pay a dividend to its owners of $500,000 costing them taxes of $75,000 (the current 15% dividend rate). The net permanent tax savings to the exporters is thus $100,000 ($175,000 - $75,000).

As you can see, the savings can be quite substantial if the IC-DISC is formed properly. There are also elections to be made and administrative and computational rules to follow, but the tax savings should greatly outweigh the cost of formation and maintenance of the IC-DISC. Please feel free to contact us if you think and IC-DISC might work for you.

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Misclassification of Workers May Result in Substantial Penalties

The IRS has increased its enforcement efforts in the area of misclassifying workers. The IRS uses three characteristics to determine whether a worker is an employee or an independent contractor: behavioral control, financial control, and the type of relationship. Generally, if the business has the right to control the work done and also how the work is done, the workers are most likely employees. If a business owner can direct or control the result of the work done, but not the means and methods of accomplishing the result, the workers are most likely independent contractors.

Employers that misclassify employees as independent contractors will face substantial financial penalties as a result of not withholding income tax, failing to withhold and pay employment taxes, and failing to file correct payroll reports and forms. The IRS penalty for unintentionally failing to withhold federal income tax is 1.5% of the wages paid. The assessment is doubled to 3% if the employer also failed to file Form 1099-MISC. The IRS penalty for unintentionally not withholding the employee's share of Social Security and Medicare taxes is 20% of the employee's share of the tax. The penalty is doubled to 40% if the employer failed to file Form 1099-MISC.

If an employer intentionally misclassifies a worker as an independent contractor, the employer is liable for the full amount of federal income tax that should have been withheld, and 100% of the employee and employer's share of Social Security and Medicare taxes. The business owner will also be subject to state penalties for misclassifying workers.

The Internal Revenue Service has increased its enforcement efforts in this area. A 1099 matching program is in place targeting individuals who only report income from one Form 1099-MISC on their personal income tax returns. The IRS is also looking for situations where a worker receives a Form 1099 from the same company over many years. In addition, many state unemployment agencies are sharing the results of their employment examinations with the IRS. Some of these cases are opened when someone who has been treated as an independent contractor stops receiving work and then files a claim for unemployment. With all these substantial penalties in effect, as well as the increased scrutiny by the IRS, companies should exercise care in classifying all of its workers.

Minimum Wage and Overtime Refresher

The Fair Labor Standards Act establishes the standards for minimum wage, overtime pay, and recordkeeping. The Act applies to enterprises with employees who engage in interstate commerce or produce goods for interstate commerce. For most firms, the Act applies when the business has more than $500,000 in volume. However, the Act also covers hospitals, institutions primarily engaged in the care of the sick, aged, and mentally or physically challenged who reside on the premises, schools and institutions of higher education, and federal, state, and local government agencies regardless of their dollar volume of business. In addition, the Act also covers domestic service workers, such as housekeepers, cooks, and full-time babysitters. The Act exempts some employees from its overtime pay and minimum wage provisions. Examples of employees exempt from the minimum wage and overtime requirements outlined in the Fair Labor Standards Act are executive, administrative and professional employees. Skilled computer professionals are also exempt. Since a large portion of the exemptions are narrowly defined, employers should verify the exact terms and conditions for each employee by contacting their local Wage and Hour Division Office.

Unless specifically exempted, employees covered by the Act must receive overtime pay for hours worked in excess of 40 in a work week. The overtime hourly rate is not less than time and one-half of their regular rates of pay. The Act does not require overtime pay for work on Saturdays, Sundays, or holidays. If an employee receives a fixed salary for a regular workweek in excess of 40 hours, the Fair Labor Standards Act still applies. The overtime requirement may not be waived by agreement between the employer and employees.

The Fair Labor Standards Act also implements a minimum wage for employees covered by the Act. The minimum wage cannot be less than $7.25 per hour. If the state minimum wage in which the individual is employed is higher than the federal wage implemented by the Fair Labor Standards Act, the minimum wage by state law is enforced. For instance, the Illinois minimum wage is $8.25, which exceeds the amount indicated in the Fair Labor Standards Act. Therefore, the Illinois minimum wage applies to employees covered by the Act.

Gift Tax Update

The Tax Relief, Unemployment Insurance Authorization and Job Creation Act of 2010 provided several updates to the estate and gift tax laws that have created planning opportunities for many individuals. In addition to these updates, there are a few permanent gifting options that should also be considered.

To give a brief summary of the taxes, gift tax is a transfer tax imposed on the transfer of wealth. Gifts of money, stock, housing, etc. should all be considered for gift tax purposes. Generation-skipping tax (GST) is an additional tax imposed on transfers to individuals that are two or more generations younger than the transferor. An example of a gift subject to the GST would be a gift from a grandfather to a grandchild. The rules for generation-skipping transfers are very complicated; if you are planning this type of a gift, please contact our office for more detailed information.

For 2011, individuals can gift up to $13,000 ($26,000 if married) to each beneficiary tax-free. This amount is excluded from gift tax and generation-skipping tax annually and is adjusted for inflation each year. Taking advantage of the annual exclusion is a great way to minimize your estate, and pass wealth without gift tax consequences.

Example 1

> Grandfather and Grandmother give Son $30,000 and Grandson $25,000. Because Grandfather and Grandmother are married, they can give up to $26,000 to each beneficiary before gift and generation-skipping tax applies. As such, the gift made to Grandson of $25,000 is entirely excluded from gift and generation-skipping tax. Of the gift made to Son, $4,000 ($30,000 less the excludable $26,000) is subject to the gift tax requirements. Generation-skipping tax does not apply to Son's gift as he is only one generation below Grandfather and Grandmother.

Additionally, the code allows for an unlimited gift and generation-skipping tax exclusion for payments made for tuition and medical care costs. Payments made directly to an educational or medical institution on behalf of another individual are not taxable. The amounts do not reduce the $13,000 annual exclusion and are completely exempt from gift and generation-skipping tax consideration. This could provide significant benefit to children or grandchildren, particularly with rising tuition and medical care costs while reducing an individual's potentially taxable estate. Please note, however, that payments need to be made directly to the institution; writing a check payable to a child or grandchild to reimburse his expenses is considered a regular gift and will be treated as a taxable gift.

Example 2

In addition to the gifts discussed in Example 1, Grandfather writes a check to the University of Illinois for Grandson's tuition of $35,000. He also pays for Son's medical expenses by writing a check payable to Northwestern Memorial Hospital for $6,000. Neither of these gifts is taxable for gift or generation-skipping tax purposes. If Grandfather wrote the check for Son's medical expenses payable to Son instead of Northwestern, then the additional $6,000 would be considered a gift, bringing the total of Son's taxable gifts to $10,000 ($30,000 plus $6,000 less $26,000 of annual exclusion).

For gifts made after December 31, 2010, the lifetime gift exemption is increased five-fold to $5 million. Through December 31, 2012, an individual can gift to all beneficiaries during his or her lifetime up to a total of $5 million without having to pay gift or generation-skipping tax. This presents a unique opportunity to shift a large portion of wealth and is particularly advantageous when there is the potential for significant appreciation of the gift.

Example 3

Uncle owns 100% of Corporation which is currently worth about $50 million. He has plans to take Corporation public in a few years, and his accountant suggested that he gift some of his stock in the business to Niece. Uncle has never made gifts before, and on December 31, 2011, he gives Niece $5,013,000 worth of stock in Corporation. Of this gift, $13,000 is allocated to the annual exclusion, reducing the taxable gift down to $5,000,000. With the increased exclusion, Uncle does not owe any gift tax on the gift and uses up his lifetime exemption.

Two years later, Corporation goes public and the $5,013,000 that he gave to Niece is now worth $10,000,000. Uncle effectively reduced his estate by $10,000,000 without having to pay any gift tax.

The provision discussed above increased the gift tax exemption by $4 million. In 2010, the lifetime exemption was only $1 million, and in 2013, it is scheduled to be reduced back down to $1 million. It is possible that legislation could reduce the $5,000,000 exemption in 2012. Therefore, it is wise to act this year.

The increased exemption is a significant estate planning opportunity and could prove to be a very useful tool in transferring wealth. However, since every individual's tax situation is unique and because of the uncertainty of future legislation, caution should be exercised before implementing a gifting program. Please contact us for more insight into how the new exemptions could be beneficial to you.

New Guidance for Employer-Provided Cell Phones Benefits Employees

The IRS has announced in its recent Notice 2011-72, that it will not tax employees' personal use of their employer-provided cell phones. In other words, all usage is nontaxable as long as the employer provided the phone primarily for noncompensatory business reasons. Likewise, employer reimbursements to their employees for using their personal cell phones for business are non-taxable.

Notice 2011-72 applies to all tax years after December 31, 2009. While the IRS did not discuss the treatment of cell phone usage before 2010, it is unlikely the agency is eager to challenge the tax-free treatment of cell phones.

Please visit our Web site, www.ssh-cpa.com, which is continuously updated with new articles and resources.

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