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## **Interest Charge - Domestic International Sales Corporations**

Permanent tax savings and more for exporters of any size or shape

Source: RSM McGladrey, Inc.

## The IC-DISC

Under economic pressure from the World Trade Organization, Congress in 2004 passed legislation to repeal a federal tax break for export sales known as the extraterritorial income (ETI) exclusion. The 2004 legislation permitted many exporters a transition period for 2005 and 2006 during which the ETI exclusion could still be claimed, but at a rate reduced from earlier years. The ETI exclusion, however, is only one of two legally designated benefits designed to reduce the burden of global income taxation on exports of U.S. – manufactured products and export-related services. The lesser known benefit, the IC-DISC, is perhaps even more powerful for many exporters. A DISC (Domestic International Sales Corporation), also known as an IC-DISC (Interest Charge DISC) is a domestic corporation that primarily engages in foreign sales and exporting activity that elects DISC status.

### Why an IC-DISC is a smart choice now

In its current form, the IC-DISC provides a permanent federal income tax savings of up to 20 percentage points for qualifying U.S. exporters. Some of these savings can be further parlayed through the deferral mechanisms that have been mainstays of the IC-DISC rules for many years.

The IC-DISC is not a listed or reportable transaction. In fact, former regulations specifically acknowledged that IC-DISCs were not tax shelters. Regarded by tax practitioners as a somewhat lackluster tax deferral vehicle, the IC-DISC largely went ignored for more than 20 years. But the introduction of the reduced tax rate for qualified dividends under Jobs and Growth Tax Relief Reconciliation Act of 2003, as currently extended through 2012 by the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, has resuscitated the IC-DISC. The IC-DISC also has a number of sophisticated features that can be tailored to help businesses meet objectives and goals.

Some IC-DISC advantages and benefits include:

- Permanent tax savings on export sales
- Increased liquidity for shareholders or the business
- Ability to leverage cost of capital
- Opportunities to create management incentives
- Means to facilitate succession or estate planning

In addition to other attributes, the IC-DISC has better staying power than the other export-oriented tax regimes. U.S. trading partners decried the legitimacy of the original DISC, the foreign sales corporation and the ETI exclusion. But the IC-DISC, which was added to the tax code in 1984, has not been challenged.

### IC-DISC structure

The typical IC-DISC structure involves an internal paper shuffle that does not affect how the exporter deals with its customers and suppliers. An IC-DISC requires only the formation of an on-shore corporation with a minimum capitalization of \$2,500, minimal paperwork to formalize the IC-DISC's relationship with the exporter, and submission of an initial tax election and subsequent annual tax returns. The IC-DISC does not have to generate customer invoices, lease office space, employ personnel or invest in fixed assets.

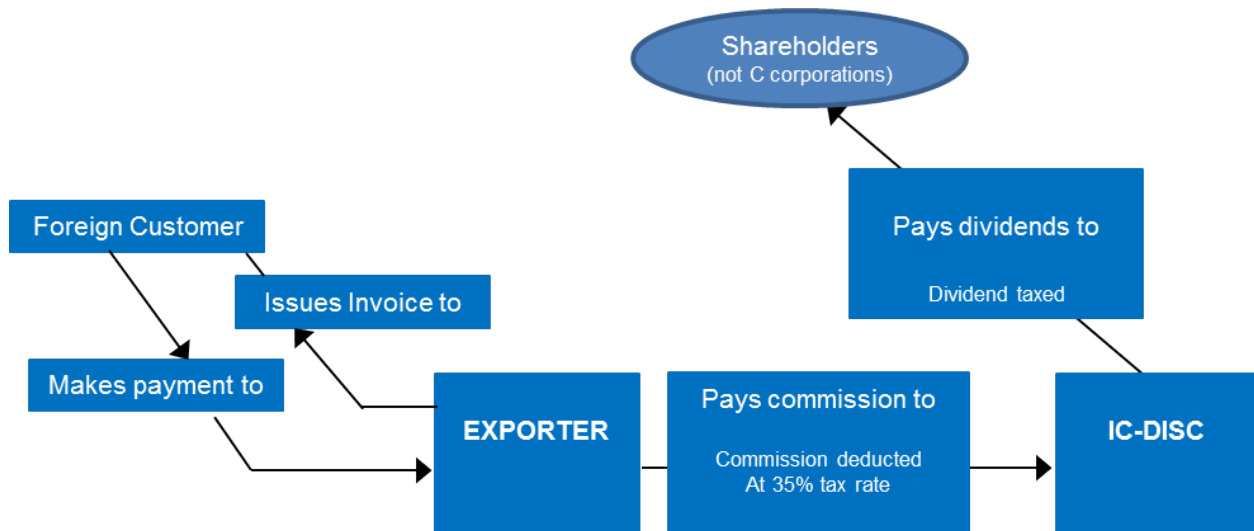
Exporters who used foreign sales corporations between 1985 and 2001 and those who computed ETI exclusions from the fourth quarter of 2000 through 2006 tackled perplexing foreign economic process requirements to get the tax savings. IC-DISCs do not have foreign economic process requirements as an obstacle to tax savings. An important feature of the IC-DISC is that there is no limitation on who can own it. Shareholders can be C corporations, S corporations, limited liability

companies, partnerships, trusts, individuals or any combination of these. In addition, foreign entities or individuals can be IC-DISC shareholders, but special rules apply to taxation of IC-DISC dividends paid to a foreign owner.

**How an IC-DISC works:**

- Exporting company or its shareholders create a corporation to become the IC-DISC.
- Shareholders of the corporation elect IC-DISC status.
- Exporting company pays IC-DISC a commission based on the profitability of export sales. The size of the commission is determined under specific statutory rules.

- Exporting company deducts commission owed to the IC-DISC from its ordinary income, taxed at a maximum federal rate of 35 percent
- IC-DISC pays no federal income tax on the commission received from exporting company. IC-DISCs are a special class of tax exempt entity.
- Shareholders that are individuals or trusts pay federal income tax on dividends at a maximum rate of 15 percent
- The result is a 20 percentage point federal tax savings on IC-DISC commissions



*The above diagram illustrates the structure and operation of a typical shareholder-owned IC-DISC. Where Exporter is a pass-through entity, it often will be the sole shareholder of the IC-DISC.*

## What an IC-DISC can do for your business

IC-DISC shareholdings can be used in a number of ways to help achieve business goals and objectives. The following are some of the advantages and benefits provided by an IC-DISC.

### **Generate permanent tax savings on export sales**

Permanent tax savings begin with the exporting company deducting the commission it pays to the IC-DISC from its ordinary income, which is taxed at 35 percent. Tax law sets the commission rate, which is based on export sales revenue, as the greater of either 50 percent of net income from the export sale or four percent of gross receipts, limited to 100 percent of net income from the export sale.

Because the IC-DISC is tax exempt, tax is paid only on distributions to shareholders. Individual shareholders pay federal income tax on dividends at a maximum rate of 15 percent. C corporations are fully taxed on dividends they receive from IC-DISCs; therefore, special considerations apply in determining who should own the IC-DISC when the exporter is a C corporation. In these circumstances, it may make sense to have the IC-DISC owned by the shareholders of the C corporation rather than the C corporation itself.

### **Make dividends paid by a C corporation tax deductible**

C corporations, especially closely held C corporations, can obtain a permanent tax savings for payments that would otherwise be made as dividends. Provided that the C corporation has sufficient profits from its exporting activities, a sister IC-DISC can earn a commission equal to the payments otherwise earmarked as dividends. An otherwise non-deductible dividend payment has been converted to a tax-deductible commission expense, while receipt of the dividend payment by the shareholders is taxed the same whether received from a C corporation or an IC-DISC.

The following example illustrates how a 20 percentage point tax rate arbitrage creates a permanent tax benefit of \$160,000 on an IC-DISC commission of \$800,000:

### **IC-DISC Net Federal Tax Savings**

		IC-DISC Commission Calculation	IC-DISC Commission Calculation
Foreign trading gross receipts	20,000,000		
Cost of goods sold	<u>-16,000,000</u>		
Gross margin	4,000,000		
Selling, general and administrative costs	<u>-3,000,000</u>		
Export net income	1,000,000		
50% of export net income		500,000	
4% of export gross receipts		800,000	
IC-DISC commission		800,000	
Federal tax saved by exporter (35%)			280,000
IC-DISC dividend to shareholders		800,000	
Federal tax cost (15%)			<u>-120,000</u>
Net federal tax savings			160,000

**Enhance shareholders' utilization of certain foreign tax credits**

Even though an IC-DISC is a domestic corporation, when the IC-DISC's only receipts consist of commissions and interest, dividends from an ICDISC constitute passive basket foreign source income in the hands of shareholders that are U.S. persons.

**Increase liquidity for shareholders or the business**

Shareholders who need to rebalance their investment risk profiles can, in most cases, use the IC-DISC to gain additional liquidity. By extracting cash in this tax-advantaged manner, they can deploy resources pursuant to their investment risk profiles.

IC-DISC liquidity also provides a tool for combating lending and debt restrictions that inhibit diversification and risk management. Rather than being reined in by restrictions, such as salary and dividend limitations and debt covenants, shareholders have flexibility to take actions that serve the best interests of the business.

**Reduce after-tax cost of capital**

An IC-DISC can also be used as a deferral tool to leverage a company's cost of capital. IC-DISC earnings need not be entirely distributed to shareholders; they can be used to parlay savings created by the lower tax rate applicable to qualified dividends. Note that the \$10 million limitation applies to how much profit the IC-DISC can retain. There is no limitation on the amount of export sales that can generate IC-DISC tax savings as long as profits from "excess" receipts are paid out as dividends back to the IC-DISC shareholders.

One method of parlaying tax savings is to lend accumulated IC-DISC earnings back to the exporting company in return for a note and interest in the form of a producer's loan. The exporting company can deduct the interest expense, and interest income is considered a dividend to the ICDISC shareholders. Reinvesting IC-DISC earnings back into the exporting business results in additional tax-rate savings and diminishes the group's cost of capital. There are limitations, however, on the size and use of a producer's loan.

Reinvestment of IC-DISC earnings in the form of a loan back to the exporting company decreases the cost of capital to the group.

**Illustration of Reinvestment of IC-DISC Earnings in the Form of Loan**

		IC-DISC Commission Calculation	Loan Consideration	Net Federal Tax Savings
Foreign trading gross receipts	20,000,000			
Cost of goods sold	<u>-16,000,000</u>			
Gross margin	4,000,000			
Selling, general and admin. costs	<u>- 3,000,000</u>			
Export sales net income	1,000,000			
50% of export net income	500,000	500,000		
4% of export gross receipts	800,000	800,000		
IC-DISC commission	800,000	800,000		
Annual loan interest deduction (5%)			40,000	
Federal tax savings (35%)				14,000
Interest income / IC-DISC dividend		800,000	40,000	
Federal tax cost (15%)				<u>-6,000</u>
Net federal tax savings				8,000
Net cost of capital (\$8,000,000 loan)	4%		32,000	

### ***Create management incentives***

Businesses can use ownership in the IC-DISC to provide incentives. Exporting company management and other personnel can be named shareholders -- allowing them to benefit from additional cash flow created by increasing global sales.

### ***Facilitate succession planning***

An IC-DISC offers a number of capabilities for executing a succession plan. Among these, ownership in the IC-DISC can be used as a means of generating cash, which can be distributed to shareholders in a tax-advantaged manner. IC-DISC shareholders participating in a buyout of current or previous shareholders can leverage these tax advantaged IC-DISC earnings to pursue the buyout plan. Alternatively, IC-DISC shares could be used as a method of freezing value.

### **Interaction with Domestic Production Activities Deduction (DPAD)**

The same 2004 legislation that repealed the ETI exclusion created a permanent tax break for domestic production activities. The DPAD was touted as the replacement for the ETI exclusion.

There is no prohibition against utilizing an IC-DISC and also claiming the DPAD on qualifying domestic production activities. With respect to a product or service that otherwise meets all the respective applicable requirements, export sales qualify for export-related tax benefits based on where the product is used, consumed or disposed of, whereas any sale -- export or domestic -- qualifies for domestic production-related benefits based on where production occurs. Everything old eventually becomes new again, and so it is with the IC-DISC. Especially because of the extension of the 15 percent federal tax rate on dividends through at least 2012, the IC-DISC merits a second (or even a first) look.