Interest Charge-Domestic International Sales Corporations: Let the U.S. Government Subsidize Your Exports

Andrew M. Berger, J.D., LL.M., Corporate, Tax and Estate Planning Practice Groups
3111 Stirling Road
Ft. Lauderdale, Florida 33312-6525
Tel: 954.364.6074
Fax: 954.985.4176
aberger@becker-poliakoff.com

If your business sells goods and/or services outside the U.S., you may be able to reduce your federal tax liability in more than half through the use of an interest charge-domestic international sales corporation (IC-DISC). This may be the case even if export sales represent a fraction of your company's overall sales.

Sound too good to be true? The IC-DISC is not an exotic strategy designed to "game" the system; it expressly sanctioned by Congress as means of promoting export sales of U.S. goods and services. IC-DISCs were actually introduced back in 1971 and were originally intended to be a tax deferral mechanism. They were used -- as my old tax professor used to say, "a tax deferred is money in your pocket" -- but never quite caught on. That all change in 2004 when amendments to the Internal Revenue Code caused dividends from qualified corporations, including IC-DISCs, to be taxed at capital gains rates of 15%. Informed exporters stampeded to take advantage of IC-DISCs, which allowed taxation of export profits to be permanently reduced from an effective rate of approximately 35% to the reduced capital gains rate for qualifying dividends.

While government statistics show that IC-DISCs remain underutilized, informed exporters continue to take advantage of the arbitrage tax savings of 20% offered by the structure; if your company is eligible, you should as well.

Candidates for an IC-DISC

- Manufacturers or distributers of products manufactured, produced, grown or extracted in the U.S. that sell or lease such products outside the U.S. or that sell such products to other U.S. companies that export such products outside the U.S.
- Architectural and engineering firms providing services for construction projects outside the U.S.
- Developers of computer software licensed for reproduction outside the U.S.
- Agricultural and mineral producers that export products outside the U.S.

What is an IC-DISC?

An IC-DISC is a domestic corporation that makes an election be treated as an IC-DISC for federal income tax purposes. Despite the connotations of its esoteric name, the IC-DISC is generally regarded as a "paper" company in that it is not required to have employees, office space or tangible assets and is not required to provide any services. The sole purpose of the IC-DISC is to receive commissions from the operating company

In order to be eligible to make the IC-DISC election, the corporation must satisfy certain technical requirements, a 95% qualified gross receipts test and a 95% qualified export test. The qualified gross receipts test is met if 95% or more of the gross receipts of the IC-DISC consist of commissions earned with respect to qualified export property, which is property (i) manufactured, produced, grown or extracted in the U.S. by a person other than an IC-DSC; (ii) is held primarily for sale, lease or rental for direct use, consumption or disposition outside the U.S.; and (iii) not more than 50% of the value of which is attributable to imported materials.

The qualified export test is satisfied if an IC-DIC's tax basis in its qualified export property (plus certain other assets) equals or exceeds 95% of the sum of the adjusted bases of all the assets of the IC-DISC at the close of the year.

Structure and Tax Benefits of an IC-DISC

In the most common structure, the operating company pays a tax-deductible "commission" payment to the IC-DISC, which is tax-exempt and therefore pays no tax on the commission. The IC-DISC then either distributes its earnings in the form of a dividend (taxable at the 15% qualified dividend rate) or defers tax by retaining all or a portion of its income. IC-DISC shareholders can annually defer the payment of tax on up to $10 million of net income attributable to qualifying export revenue (at the cost of a small interest charge), so long as the corporation reinvests such income in the export business.

The amount of federal income tax benefit that may be achieved by utilizing an IC-DISC structure depends both on the amount of the operating company's export sales and the amount of commission that may be paid to the IC-DISC. Generally, the commission is determined by analyzing three potential formulas provided in the Internal Revenue Code, and choosing the one that maximizes the benefit in a taxpayer's particular circumstance. The key takeaway, though, is that the business owners receive a 20% tax savings on the amount of the commission paid – i.e., the difference between the 35% ordinary income tax rate and the 15% qualified dividend rate.

In addition to the foregoing tax savings, the IC-DISC can also provide a number of ancillary benefits. For example, dividend distributions from the IC-DISC are not subject to Federal Social Security (FICA), Medicare, or self-employment taxes. Also, because the IC-DISC is not required to be owned by, or in the same manner as, the operating company, a significant estate planning opportunity is available.

It should be noted that separate and apart from the commission income, an IC-DISC may be able to purchase accounts receivable from the affiliated exporter at a discount (on a factoring basis), and to conduct certain promotional activities fro the operating company on a cost-plus basis. Where applicable, these additional items of income would not count against the annual limitation of $10 million of qualifying net income, and would be eligible for either current distribution at the preferred rates applicable to dividends or deferral.

No Impact on Business Operations

As mentioned above, the IC-DISC is merely "paper" company; it does not perform any services or engage in any activities that in would in any way impact the operating company's business operations or day-to-day dealings with its customers. The operating company continues to provide the services and bill its customers, who do not even know the IC-DISC exists.

Conclusion

Properly structured and implemented, an IC-DISC can provide an enormously powerful vehicle for reducing and/or deferring an exporter's income tax liability. While the concept is simple, the rules can be complex and the intercompany documents need to be carefully drafted. It is necessary for a business owner to consult a legal advisor to determine whether they may benefit from an IC-DISC based on their particular situation.

If you would like to determine whether you may be eligible to take advantage of the tax breaks offered by an IC-DISC, please contact Andrew Berger at 954-364-6074 or **aberger@becker-poliakoff.com**. ■

Andrew Berger *is a tax and estate planning attorney with Becker & Poliakoff, P.A. He received his LL.M. in Taxation from New York University School of Law, his J.D. from Fordham University School of Law, and his B.A. from Emory University. He is admitted to practice law in Florida, New York and New Jersey.*