



# THE IC-DISC THE LAST BIG TAX BREAK FOR EXPORTERS?

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Does your company export goods manufactured, produced, grown, or extracted in the United States? If so, consider establishing an Interest Charge Domestic International Sales Corporation (“IC-DISC”). The IC-DISC is a valuable and relatively simple tool, which can result in real tax savings for qualifying exporters and even certain architectural and engineering firms.

By no means is the IC-DISC a “new” concept. It has been around since 1971 in one form or another. However, it continues to provide permanent tax savings to U.S. exporters in an otherwise uncertain time. The IC-DISC remains the *only* tax incentive plan specifically designed to subsidize U.S. exporters, and now is the time to take advantage of its unique benefits.

## WHAT IS AN IC-DISC?

An IC-DISC is a C-corporation that exists separate and apart from its parent or affiliated exporting company (such parent or

affiliated company, the “Exporter”). The IC-DISC need not have the same stockholders as the Exporter, it need not have employees or provide services, and it may be organized under the laws of any state or the District of Columbia. However, the IC-DISC must meet certain standards and qualifications and also receive approval from the Internal Revenue Service (the “IRS”) to be classified as an IC-DISC under Section 992(a)(1) of the Internal Revenue Code of 1986.

Although it is a C-Corporation, an IC-DISC will not be subject to federal income tax at the corporate level. When combined with the Exporter’s ability to deduct commissions paid to the IC-DISC, this special treatment is the key to the IC-DISC’s power as a tax-planning tool.

## WHO IS QUALIFIED?

To qualify as an IC-DISC, a corporation must:

- File an election and be approved by the

IRS to receive IC-DISC treatment.

- Be incorporated under the laws of any state or the District of Columbia.
- Have only one class of stock.
- Maintain a minimum capitalization of \$2,500 of authorized and issued stock.
- Maintain a separate bank account, books and records apart from the Exporter.
- Meet the IRS’s annual qualified export receipts test (at least 95% of the IC-DISC’s annual receipts must be qualified export receipts).
- Meet the IRS’s qualified export assets test (at least 95% of the assets held by the IC-DISC at year-end must consist of qualified export assets).

Proper organization of the IC-DISC is crucial, or else the intended tax benefits will not be realized (regardless of whether all of the above requirements are met). For example, if the existing Exporter is a pass-through entity (such as an S-corporation,

partnership, or limited liability company), then the IC-DISC can be organized as a wholly-owned subsidiary of the Exporter. However, if the existing Exporter is a C-Corporation, then the individual stockholders of the Exporter (and not the Exporter itself) should organize and own the IC-DISC. Otherwise, the IC-DISC's income will be distributed out to the C-corporation and taxed at ordinary income rates and no tax benefit will be realized.

### HOW DOES IT WORK?

Once the IC-DISC has been properly organized, the Exporter and IC-DISC will take the following steps down the path to joint tax savings:

**Step One:** The IC-DISC and the Exporter enter into a written Exporter Commission Agreement, where the Exporter engages the IC-DISC to act as its agent for the sale of the Exporter's goods (or architectural or engineering services) outside the United States.

**Step Two:** The Exporter sells its goods, and pays tax-deductible commissions to the IC-DISC equal to the greater of 4% of the Exporter's qualified export receipts, or 50% of the Exporter's taxable income. Again, the IC-DISC need not provide any actual services to the Exporter.

**Step Three:** The Exporter deducts the commissions paid to the IC-DISC in full, and the IC-DISC distributes its income to its stockholder(s) at the qualified dividend rate (versus the higher tax rates on ordinary income).

### WHAT ARE THE TAX SAVINGS?

The IC-DISC is not a new or "risky" vehicle for tax savings. In fact, the concept has existed in one iteration or another since 1971. Despite multiple challenges by Congress over the years and occasional pressure by foreign governments, the IC-DISC continues to exist and flourish.

The latest threat to the IC-DISC arose at the conclusion of 2012, amid speculation that Congress intended to repeal preferred rates on qualified dividends. As we all know, Congress ultimately chose to keep a preferred rate, albeit raising the top dividend tax rate from 15% to 20% as part of the deal struck under the American Taxpayer Relief Act of 2012 (the "Act"). In addition, the Act instituted a 3.8% Unearned Income Medicare Contribution Tax, resulting in an effective dividend tax rate of 23.8% for top earners and 18.8% for the lower bracket. Regardless, even this top rate of 23.8% is lower than the top ordinary income tax rate of 39.6% (raised from 35.6%). Thus, although the rate on dividends was increased,

U.S. exporters still stand to achieve potential income tax savings of no less than 15.8% by virtue of IC-DISC implementation.

Given the relatively low cost required to form an IC-DISC, qualifying U.S. exporters should not be deterred from forming an IC-DISC despite the Act's increase on dividend rates. The tax-savings in the first year alone will far outweigh the minimal professional fees required.



### WHAT OTHER BENEFITS CAN IC-DISC'S PROVIDE?

The benefits of the IC-DISC stretch beyond the tax savings on federal income. One draw of the IC-DISC is that it is not *required* to maintain an office, hire employees or perform services. However, having the IC-DISC perform certain services, such as promotion of the Exporter's activities, can result in additional tax savings. As with the IC-DISC commissions, any qualifying income earned from such services provided by the IC-DISC can be distributed to stockholder(s) at the reduced qualified dividend tax rate.

Another draw of the IC-DISC is that there is no requirement that the stockholder(s) of the IC-DISC be the same as the stockholders of the Exporter. As a result, employees, company founders, prior owners, and others can be rewarded with stock and/or dividends of the IC-DISC. In such cases, dividends from the IC-DISC can act as annual bonuses or commissions paid on export sales. Assuming employees qualify for a tax rate of only 15%, this structure can be used as a valuable tool to convert em-

ployee bonuses from ordinary income to lower-taxed dividend income.

Finally, IC-DISC stock can also defer up to \$10 million of net income of export sales per year on qualifying export revenue, so long as the IC-DISC reinvests a certain portion of the income in the Exporter.

### WILL THE TAX BENEFITS LAST?

In his 2010 State of the Union Address, President Obama pledged to double U.S. exports by 2015. Whether we achieve this ambitious goal remains questionable. However this promise will most certainly be broken if the tax incentives provided by the IC-DISC are further whittled away by Congress. Given this pledge and the overall economic uncertainty still facing the United States, it seems highly unlikely that either the current administration or Congress would choose to disarm the IC-DISC in the foreseeable future.

### WHEN TO ACT?

Because the tax benefits of the IC-DISC are not retroactive, an Exporter can only begin to receive such benefits after the IC-DISC is established. Therefore, the sooner an Exporter makes the decision to form an IC-DISC, the better.

This article is not exhaustive of the requirements or applications of IC-DISC rules. Any business considering the formation of an IC-DISC must consult with their tax and legal representatives to determine their eligibility and whether an IC-DISC will offer potential tax savings or other benefits in their particular situation.



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