Interest-charge domestic international sales corporations

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

Prepared by:

David Luzi, Partner, RSM US LLP
dave.luzi@rsmus.com, +1 847 413 6250

Jonathan Hobbs, Senior Director, RSM US LLP
jonathan.hobbs@rsmus.com, +1 612 376 9565

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Summary

An interest-charge domestic international sales corporation (IC-DISC) can be a powerful tax-savings opportunity for many companies exporting products. An IC-DISC is a domestic corporation that primarily engages in foreign sales and exporting activity. Many years ago, the U.S. government created this law as a means to promote U.S. business activities it deemed economically beneficial. In today's competitive global landscape, any cost-saving measures are coveted.

The beauty of the IC-DISC structure is that in order to capture the tax benefits, very little, if any, change is required in how your business is already being conducted. In general, the structure is invisible to your customers, but the benefits will save you money.

Why an IC-DISC is a smart choice now

In its current form, the IC-DISC provides a permanent federal income tax savings for qualifying pass-through U.S. exporters and closely held corporate U.S. exporters.[1] 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 the Jobs and Growth Tax Relief Reconciliation Act of 2003, as currently extended through the American Taxpayer Relief Act of 2012, 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 its 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 extraterritorial income exclusion. However, the IC-DISC, which was added to the tax code in 1984, has not been challenged.

IC-DISC structure

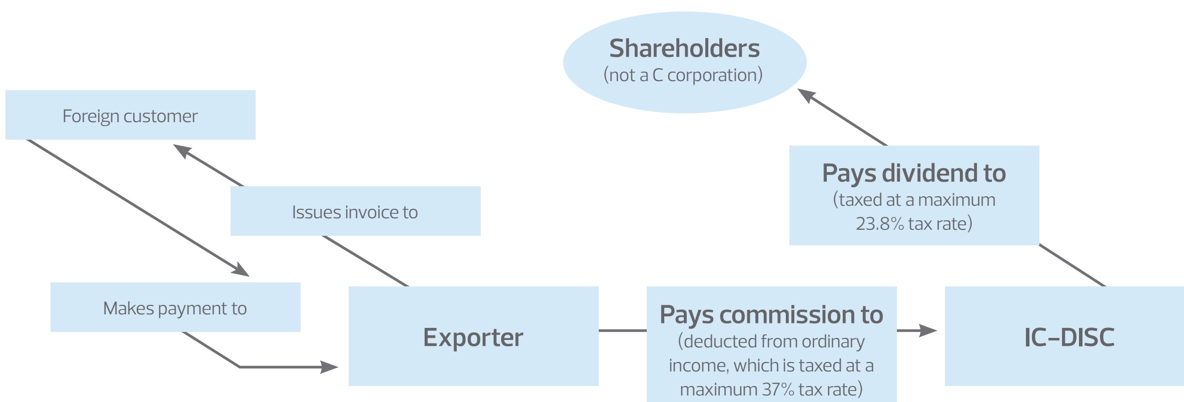
The typical IC-DISC structure involves internal computations and support but does not affect how the exporter deals with its customers and suppliers. An IC-DISC requires the formation of an onshore corporation with minimal capital, contractual agreements to formalize the IC-DISC's relationship with the 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.

An important feature of the IC-DISC is that there is no limitation on who can own it. Shareholder structures can accommodate C corporations, S corporations, limited liability companies, partnerships, trusts, individuals or any combination of these owners. In addition, foreign entities or individuals can be IC-DISC shareholders, but special rules apply to the taxation of IC-DISC dividends paid to a foreign owner.

How an IC-DISC works

- The exporting company or its shareholders create a domestic corporation to become the IC-DISC.
- The shareholders of the corporation elect IC-DISC status.
- The exporting company pays the IC-DISC a commission based on the profitability of the export sales.
- The size of the commission is determined under specific statutory rules.
- The exporting company deducts the commission owed to the IC-DISC from its ordinary income, which is taxed at a maximum federal rate of 37%, although the deduction for qualified business income (section 199A deduction) could reduce this rate to 29.6%.
- The IC-DISC pays no federal income tax on the commission received from the 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 23.8%.
- The result typically provides a 5.8% (if section 199A applies) to 13.2% federal tax savings on IC-DISC commissions.[2]

This diagram illustrates the structure and operation of a typical shareholder-owned IC-DISC. When the exporter is a pass-through entity, it often will be the sole shareholder of the IC-DISC.



[1] In limited circumstances, the permanent federal tax savings could be up to 13.2%.

[2] In certain cases involving passive shareholders, the use of the IC-DISC can produce a tax savings of up to 13.2%.

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. 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 up to 37% (more commonly 29.6% after the qualified business income deduction). Tax law generally sets the commission rate as the greater of either 50% of taxable income from the export sale or 4% of gross receipts, limited to 100% of net income from the export sale, although there are even methods that allow a commission to be paid on transactions that are not profitable.

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 23.8%. 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.

The following example illustrates how a 5.8% tax rate arbitrage creates a permanent tax benefit of $46,400 on an IC-DISC commission of $800,000:

IC-DISC net federal tax savings

		IC-DISC commission calculation	Net federal tax savings
Foreign trading gross receipts	$ 20,000,000		
Cost of goods sold	– 16,000,000		
Gross margin	$ 4,000,000		
Selling, general and administrative costs	– 3,000,000		
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 (29.6%)			$ 236,800
IC-DISC dividend to individual shareholders		$ 800,000	
Federal tax cost (assumes 23.8 percent rate)			– 190,400
Net federal tax savings			$ 46,400

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 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. Thus, an otherwise nondeductible dividend payment can be 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 benefit to a closely held C corporation exporter on an $800,000 IC-DISC commission in such a structure would be 21% of $800,000, or $168,000.

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 IC-DISC 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.

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.

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 IC-DISC 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.

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.

+1 800 274 3978
rsmus.com

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