



September, 2006

Mr. A. Smith  
ABC Smith Company

Dear Mr. Smith:

### **Interest Charge-Domestic International Sales Corporation (IC-DISC) Come Back into Favor as a Viable Tax Savings Strategy**

2006 marks the last year that most U.S. exporters can claim the export tax benefit associated with the extraterritorial income (“ETI”) exclusion due to its repeal, which will certainly create a tax-savings void for some exporters. However, there is still good news for small and mid-sized companies. Owner-managed exporting businesses can recoup — or even exceed — their tax savings by creating an interest charge-domestic international sales corporation (“IC-DISC”).

The IC-DISC is not a tax shelter. Once a somewhat lackluster tax deferral vehicle, it was revamped last July by favorable dividend tax rules prescribed under the Jobs and Growth Tax Relief Reconciliation Act of 2003.

In its new form, the IC-DISC provides a permanent 20 percent tax savings for qualifying U.S. exporters. It also has a number of sophisticated features that can be tailored to help businesses meet objectives and goals.

#### **IC-DISC advantages and benefits:**

##### Permanent tax savings on global sales

Permanent tax savings begins 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 or 4 percent of gross income. Because the IC-DISC is tax exempt, tax is paid only on distributions to shareholders. Individual and pass-through company shareholders pay income tax on dividends at the capital gains rate of 15 percent.

**EXAMPLE:** The following example illustrates how a 20 percent tax rate arbitrage creates a permanent tax benefit of \$160,000 on a commission of \$800,000.

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 sales net income	1,000,000
IC-DISC commission (greater of):	
50% of export net income	500,000
4% of export gross receipts	800,000



IC-DISC commission	800,000	
Federal tax savings (35%)	280,000	
IC-DISC dividend		800,000
Federal tax cost (15%)		(120,000)
IC-DISC net tax savings		160,000

Increased 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.

Ability to leverage cost of capital

An IC-DISC is more than a tax-savings vehicle. It can also be used as a deferral tool to leverage a company's cost of capital. IC-DISC earnings need not be distributed to share-holders; they can instead be used to perpetuate and grow the deductible dividend tax-rate savings. Tax-rate savings is perpetuated by lending accumulated IC-DISC earnings back to the exporting company in return for a note and interest. 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.

**EXAMPLE:** In the following example, reinvestment of IC-DISC earnings in the form of a loan back to the exporting company decreases the cost of capital to the group.

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 sales net income	1,000,000	
IC-DISC commission (greater of):		
50% of export net income	500,000	
4% of export gross receipts	800,000	
IC-DISC commission	800,000	
Annual loan interest deduction (5%)	40,000	
Federal tax savings (35%)	14,000	
IC-DISC dividend		40,000
Federal tax cost (15%)		(6,000)
IC-DISC net tax savings		8,000
Net cost of capital (\$800,000 loan)		4.00%



### Opportunities to 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.

### Means to facilitate succession planning

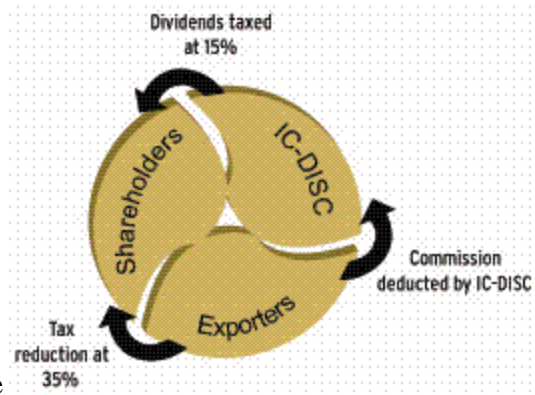
An IC-DISC offers a number of capabilities for executing a succession plan. Among these, ownership in the IC-DISC can be used as a means of generating cash, which can be distributed to shareholders in a tax-advantaged manner. IC-DISC shareholders participating in a buyout of current or previous shareholders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

### **The IC-DISC structure**

The IC-DISC is a “paper” entity utilized as a tax-savings vehicle. It does not require corporate substance or form, office space, employees or tangible assets. It simply serves as a conduit for export tax savings. An important feature of the IC-DISC is that shareholders can be corporations, individuals or a combination of these.

### **How an IC-DISC works:**

- Owner-managed exporting company creates a tax-exempt IC-DISC
- Exporting company pays IC-DISC a commission
- Exporting company deducts commission from ordinary income taxed at 35 percent
- IC-DISC pays no tax on the commission
- Shareholders pay income tax on dividends at the capital gains rate of 15 percent
- Result is 20 percent tax savings on commission



### **Does your company Qualify?**

In addition to other attributes, the IC-DISC has better staying power than its predecessors. U.S. trading partners decried the legitimacy of both the foreign sales corporation and the ETI exclusion. But the IC-DISC, which was added to the tax code in 1984, has never been challenged.

For U.S. exporters, the Interest Charge-Domestic International Sales Corporation (IC-DISC) will soon be the only remaining tax-saving opportunity. If you are unsure about whether or not an IC-DISC will work for you, ask yourself the following questions:



Do you have any transactions outside of the United States? Do you use overseas distribution?  
Does your product cross any borders?

If you answered yes to any of these questions, then an IC-DISC could be a valuable tax-savings vehicle for your business.

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