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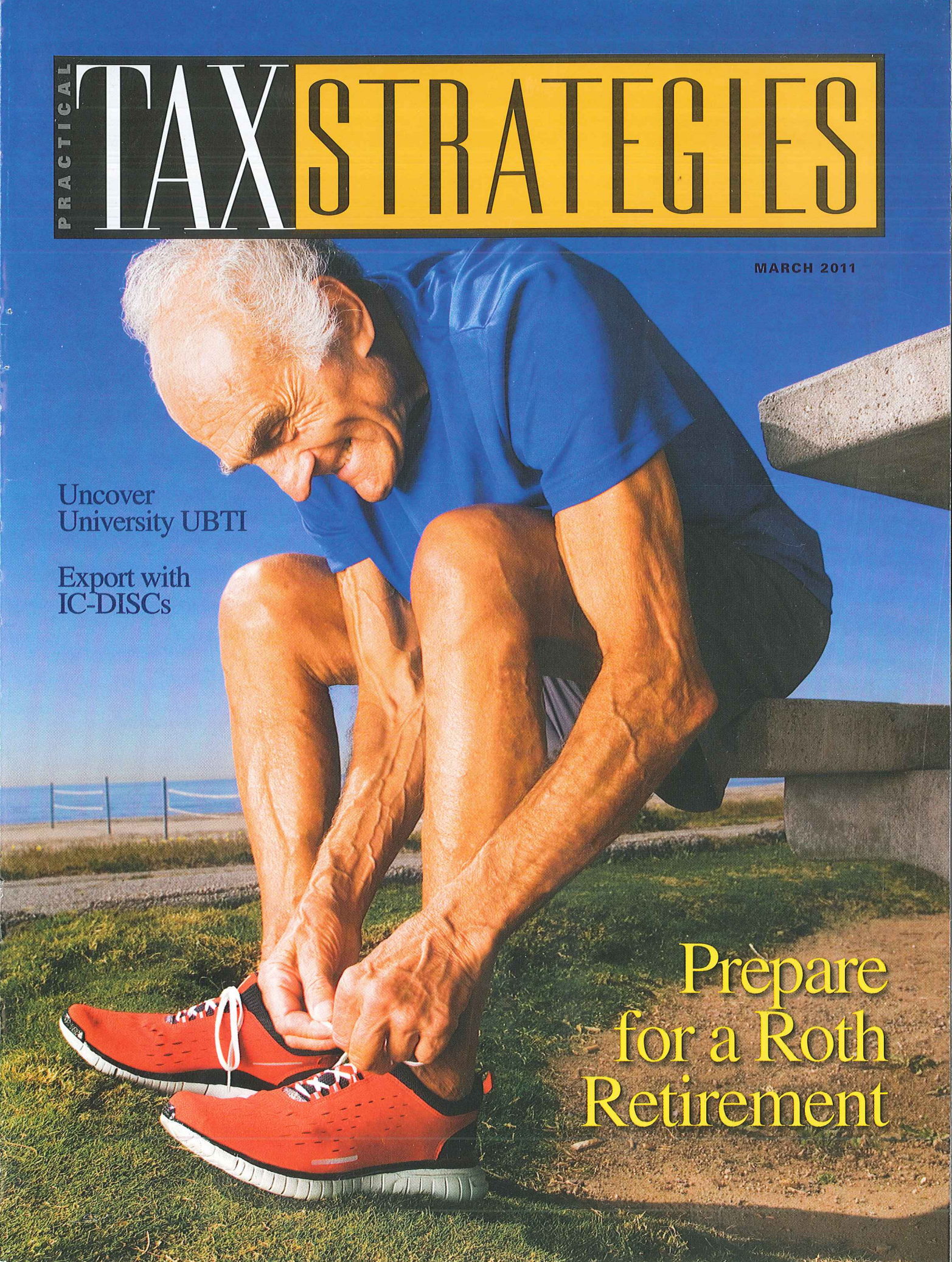
TAX STRATEGIES

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THE LAST REMAINING EXPORT INCENTIVE JUST GOT SOME STAYING POWER

RYAN L. LOSI

An IC-DISC can provide a permanent 20% tax savings (or even more) for qualifying U.S. exporters.

U.S. exporters, both domestic and foreign owned, take note. An old and in most cases forgotten export regime known as the Interest Charge-Domestic International Sales Corporation (IC-DISC), which dates back to the 1970s, has reared its head again as an extremely beneficial tax savings strategy. It has staying power now, with support existing in both Houses of Congress and the White House.

Background

For U.S. exporters operating their business via a sole proprietorship or pass-through entity (e.g., limited liability company (LLC), S corporation, limited partnership (LP)), the IC-DISC benefit is essentially tied to the differential between the qualified dividend rates and the ordinary income tax rates. This differential was originally set to expire on 12/31/10 but Congress extended it in late December of 2010 to 12/31/12.¹ Many international tax practitioners strongly believe, as does this author, that this differential will be extended past 2012 even if tax rates on ordinary income in-

crease. In addition to benefiting sole proprietorships and pass-through entities, exporters operating their business via a C corporation can benefit by using the IC-DISC to eliminate double taxation on a majority of their export income, as well as to reduce the need to incur additional payroll taxes on income paid to their shareholders/officers.

Congress has a long history of providing export incentives to U.S. companies that export U.S. produced goods and certain services. Over the years, many of these incentives have come and gone, but the IC-DISC has remained. In 2007, the IC-DISC became the last remaining U.S. export incentive. Many, including the author, thought the Obama administration would target the IC-DISC regime and end the tax savings it provided U.S. exporters. However, that was before the "Great Recession" set in, leading to a renewed focus on creating U.S. jobs, which became the top priority of our leaders in Washington. Now it is apparent that the IC-DISC is here to stay; exporters would be foolish not to explore this export tax incentive.

Exporters can now recoup, or even exceed, their tax savings on their product revenue—and in some cases service revenue as well—by creating an interest charge-domestic international sales corporation. This benefit is also

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EXHIBIT 1
How an IC-DISC works

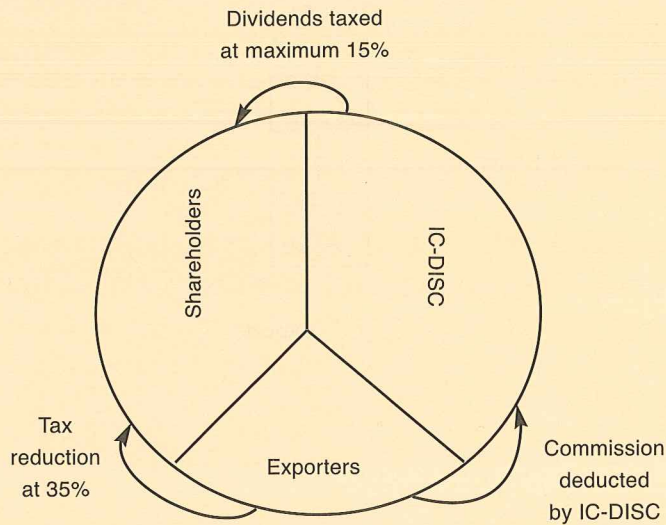


EXHIBIT 2
Tax savings—20% tax rate arbitrage

Foreign trading gross receipts (Export Sales)		5,000,000	
Cost of goods sold		(3,000,000)	
Gross Margin		2,000,000	
Selling, general and administrative costs		(1,000,000)	
Export sales net income		1,000,000	
IC-DISC commission (greater of):			
50% of export net income	500,000		
4% of export gross receipts	200,000		
IC-DISC commission		500,000	
Federal tax savings (35%)		175,000	
IC-DISC dividend			500,000
Federal tax cost (15%)			(75,000)
IC-DISC net tax savings			100,000

available to companies whose products are exported by another party or “ultimately used” outside the U.S. by customers.

The IC-DISC is not a tax shelter. It once was a somewhat lackluster tax deferral vehicle, but it was revamped a few years ago under the Bush Administration by very favorable dividend tax rules prescribed under the Jobs and Growth Tax Relief Reconciliation Act of 2003.

To qualify as an IC-DISC, a domestic corporation must pass two main tests known as the qualified export receipts test and the qualified export assets test. The qualified export receipts test requires that 95% of the gross receipts of the

IC-DISC constitute qualified export receipts.² Qualified exports receipts include gross receipts from the sales or exchange of export property, rents for the use of export property outside the U.S., services related to export sales or rents, engineering or architectural services for projects located outside the U.S. and commissions thereon.³ The qualified export assets test requires that 95% of the assets of the IC-

¹ Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, P.L. 111-312, section 102.

² Section 992(a)(1)(A).

³ Section 993(a).

EXHIBIT 3
IC-DISC as a subsidiary of an S corporation or another flow-through entity

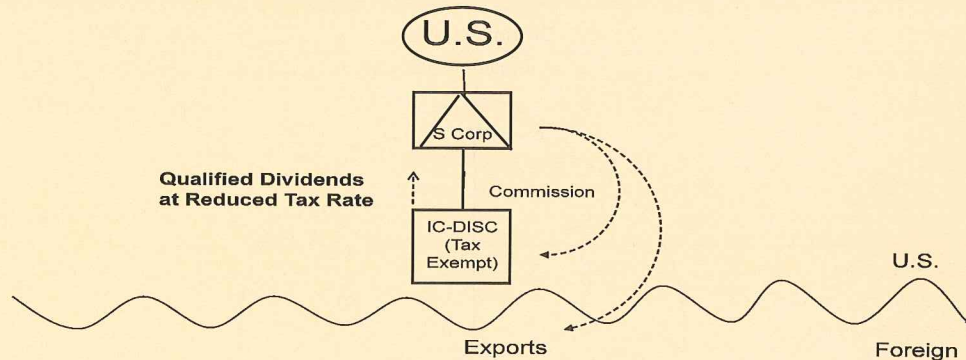
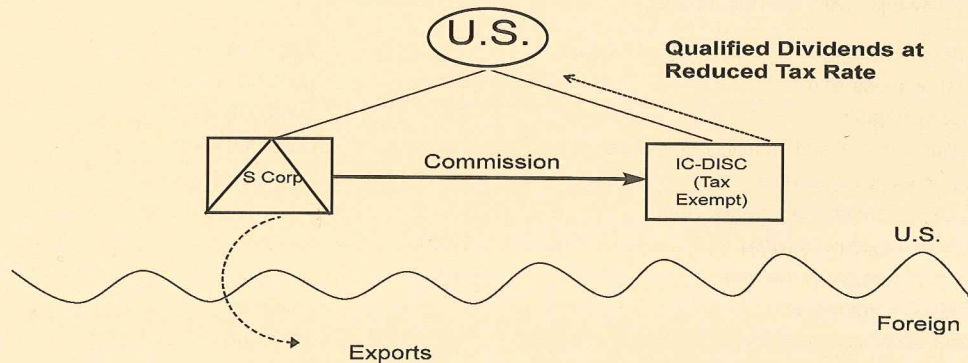


EXHIBIT 4
IC-DISC as a brother-sister entity of an S corporation or another flow through entity



DISC be qualified export assets.⁴ Qualified export assets include accounts receivable, temporary investments, export property, and loans to producers.⁵

Because most of the qualified export receipts categories focus on export property, it is critical that the exporter substantiate that its exports satisfy the definition of export property. Three requirements must be met in order for the IC-DISC to receive in-

come from an export sale.⁶ The export property must:

1. Be manufactured, produced, grown, or extracted in the U.S. by a person other than the IC-DISC.
2. Be held primarily for sale, lease, or rental for use, consumption, or disposition outside the United States
3. Have a maximum of 50% foreign content.

Although exporters often think of newly produced property as export property, used equipment and even scrap also qualify.

In its most recent form, the IC-DISC can provide a permanent 20% tax savings (or even more) for qualifying U.S. exporters. In certain cases, it eliminates U.S. tax entirely on the major-

⁴ Section 992(a)(1)(B).
⁵ Section 993(b).
⁶ Section 993(c).
⁷ Section 995(f).
⁸ Section 995(b).
⁹ Section 995(b)(1)(E).

EXHIBIT 5**Tax savings—20% tax rate arbitrage**

Foreign trading gross receipts (export sales)	\$5,000,000		
Cost of goods sold	(3,000,000)		
Gross Margin	2,000,000		
Selling, general and administrative costs	(1,000,000)		
Export sales net income	1,000,000		
IC-DISC commission (greater of):			
50% of export net income	500,000		
4% of export gross receipts	200,000		
IC-DISC commission	500,000		
Fed corporate tax savings (35%)	175,000		
Fed shareholder tax savings (\$325K × 15%)	48,750		
IC-DISC dividend		500,000	
Federal tax cost (15%)		(75,000)	
IC-DISC net tax savings			\$148,750

ity of export income. It also has a number of sophisticated features that can be tailored to help export businesses meet their objectives and goals. Prior to 2003, the major tax benefit of the IC-DISC to U.S. exporters was deferral of U.S. tax on the commission income for up to \$10 million in annual export sales (qualified export receipts). The deferral can be indefinite and is only minimally taxed as an interest charge to the U.S. shareholder on the deferred tax liability.⁷ In addition, distributions to individual shareholders are currently taxed at a maximum rate of 15%—providing a way to convert 35% ordinary income to 15% qualified dividend income.⁸ Of course, this assumes that the U.S. exporter generates operating profits and is creating taxable income in the U.S. However, sophisticated transactional studies can be performed to ensure the IC-DISC benefit is obtained, even if the U.S. exporter generates a “tax loss.”

IC-DISC structure

The IC-DISC is a “paper” entity used 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.

This is how an IC-DISC works (see Exhibit 1):

- Owner-managed exporting company forms a special U.S. corporation that elects to be an IC-DISC. The election is made on Form 4876-A. The form must be filed within 90 days after the

beginning of the tax year. For any tax year that is not the corporation’s first tax year, the election must be made during the 90-day period immediately preceding the first day of that tax year.

- Exporting company pays IC-DISC a commission.
- Exporting company deducts commission from ordinary income taxed at up to 35%.
- IC-DISC pays no tax on the commission as long as certain qualification standards are met such as the 95% qualified export assets and the 95% qualified export receipts requirements of Section 992(a)(1). Qualified export receipts in excess of \$10 million per year are not eligible for deferral of tax⁹ although deferral should not be a primary objection during this low-tax dividend environment.

An important feature of the IC-DISC is that shareholders can be corporations, individuals, or a combination of these.

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EXHIBIT 6
IC-DISC should only be brother-sister entity of a C corporation

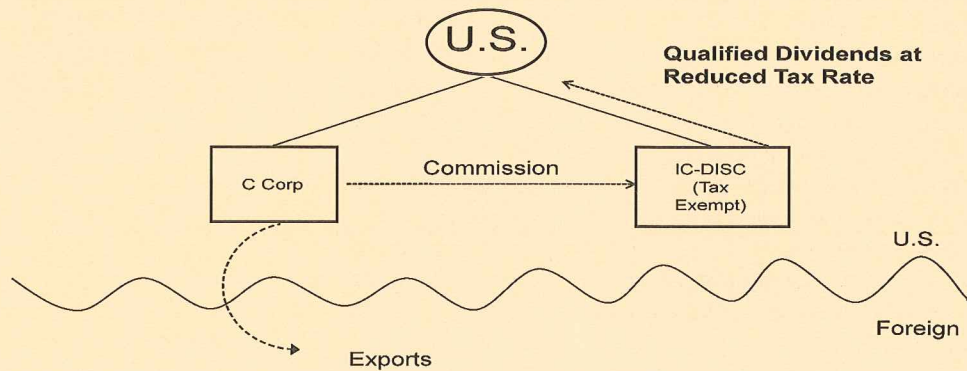


EXHIBIT 7
Tax savings—100% tax rate arbitrage

Foreign trading gross receipts (export sales)		\$5,000,000	
Cost of goods sold		(3,000,000)	
Gross Margin		2,000,000	
Selling, general and administrative costs		(1,000,000)	
Export sales net income		1,000,000	
IC-DISC commission (greater of):			
50% of export net income	500,000		
4% of export gross receipts	200,000		
IC-DISC commission		500,000	
Fed corporate tax savings (35%)		175,000	
Fed shareholder tax savings (\$325K x 30%)		48,750	
IC-DISC dividend			500,000
Federal tax cost (0%)			(0)
IC-DISC net tax savings			\$223,750

- Shareholders of an IC-DISC are not taxed until the earnings are distributed as dividends. However, the shareholders must pay annual interest on the tax deferred.¹⁰ The interest charge is computed on Form 8404. Shareholders that are individuals pay income tax on qualified dividends at the capital gains rate of 15%. C Corporation shareholders are automatically considered to have received 1/17th of the IC-DISC's
- taxable income even if no distributions are made.¹¹
- The result may be a 20% or more tax savings on commission.

IC-DISC advantages and benefits.

The following sections describe some of the advantages and benefits that result from using the IC-DISC.

Permanent tax savings on global 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

¹⁰ Section 995(f)(1).

¹¹ Section 995(b)(1)(F)(i).

¹² Section 994(a).

PLANNING TIP

On the surface, the rules covering the IC-DISC may seem simple. However, to maximize the tax benefit, an international tax firm that specializes in this complex structure should be engaged to manage the IC-DISC on a quarterly basis. Many times IC-DISC experts can double if not triple the tax benefit the IC-DISC provides by applying their in-depth understanding of how to structure the IC-DISC and using the complex advance pricing rules the Code allows for determining the tax benefit. Depending on the service, the cost of an outside expert can vary from as little as \$2,500 to over \$100,000. A firm that has proven IC-DISC expertise, offers fixed fees, and optimizes the IC-DISC on a transactional basis (which almost always provides the best result) should be chosen.

35%. Tax law sets the commission rate, which is based on export sales revenue, as the greater of either 50% of net export income or 4% of export sale revenue.¹² 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 qualified dividends at the long-term capital gains rate of 15%.

Example 1: Exhibits 2-4 illustrate how a 20% tax rate arbitrage creates a permanent tax benefit of \$100,000 on a commission of \$500,000 for pass-through companies such as sole proprietorships, single member LLCs, tax partner-

ships, S corporations, and LLCs electing to be taxed as partnerships.

Example 2: Exhibits 5 and 6 illustrate how a 29.75% tax rate arbitrage creates a permanent tax benefit of \$148,750 on a commission of \$500,000 for taxable companies such as C corporations and LLCs electing to be taxed as corporations. Unlike pass-through businesses, owners of C corporations incur two levels of taxation. One is at the corporate level and the second is at the shareholder level. This explains the heightened tax savings that C corporations

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EXHIBIT 8
Foreign parent from country with a recently ratified treaty with U.S.
can take advantage of reduced treaty rates

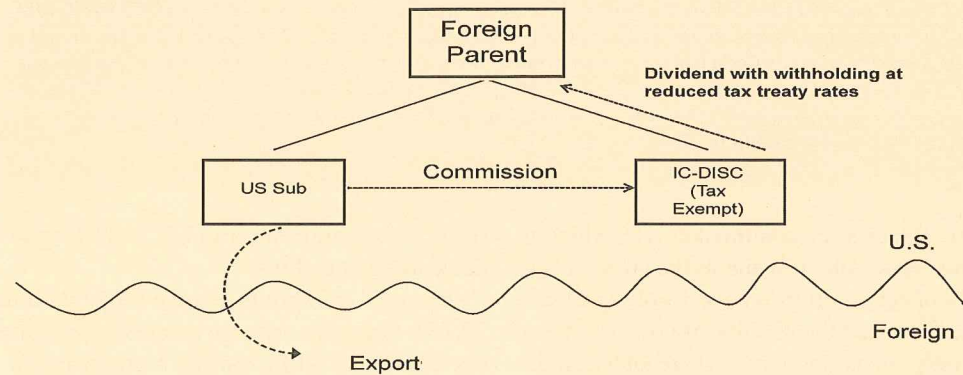


EXHIBIT 9
Tax savings—leverage cost of capital

Foreign trading gross receipts		\$5,000,000	
Cost of goods sold		(3,000,000)	
Gross margin		2,000,000	
Selling, general and administrative costs		(1,000,000)	
Export sales net income		1,000,000	
IC-DISC commission (greater of):			
50% of export net income	500,000		
4% of export gross receipts	200,000		
IC-DISC commission		500,000	
Annual loan interest deduction (5%)		25,000	
Federal tax savings (35%)		8,750	
IC-DISC dividend		25,000	
Federal tax cost (15%)		(3,750)	
IC-DISC net tax savings		5,000	
Net cost of capital (\$500,000 loan)			4.00%

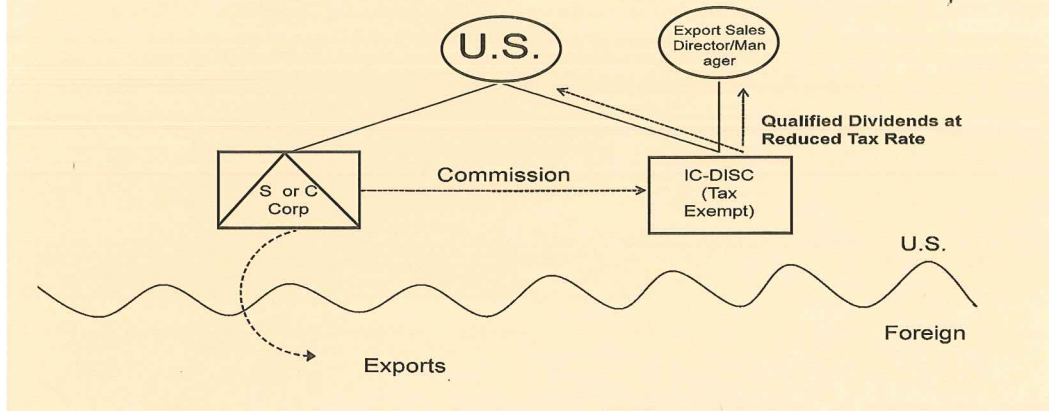
receive over pass-through businesses when using the IC-DISC.

Example 3: Exhibits 7 and 8 illustrate how a 100% tax rate arbitrage creates a permanent tax benefit of \$223,750 on a commission of \$500,000 for taxable companies such as C corporations and LLCs electing to be taxed as corporations that are subsidiaries of foreign corporations located in a country having a favorable income tax treaty with the U.S. that was ratified after 1984 (e.g., Mexico, United Kingdom, and Japan) and maintaining a 80% or greater ownership in the U.S. subsidiary. In this example, all U.S. tax is eliminated entirely.

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

EXHIBIT 10
Opportunities for management incentives



used as a deferral tool to leverage a company's cost of capital. IC-DISC earnings need not be distributed to shareholders; they can instead be used to perpetuate and grow the deductible dividend tax rate savings. Tax rate savings are 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 4: Exhibit 9 reflects a reinvestment of IC-DISC earnings in the form of a loan (i.e., producer loan) back to the exporting company, which decreases the cost of capital to the group. Currently, however, the qualified dividend tax rate remains at a historic low; thus, many international tax practitioners would strongly recommend distributing the earnings in the form of a qualified dividend in order to capture/preserve the current low dividend tax rate on this income. Once the dividend is in the hands of the shareholders, they can determine how best to deploy the capital, after the low tax rate has been preserved.

Opportunities to create management incentives.

Businesses can also use ownership in the IC-DISC to provide incentives. Exporting company management and other personnel can be named as shareholders, which allows them to benefit from

additional cash flow created by increasing global sales. (See Exhibit 10.)

Means to facilitate succession planning. An IC-DISC offers a number of ways to execute 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.

Conclusion

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

For U.S. exporters, the IC-DISC is the *only* remaining tax-saving opportunity. If you are unsure about whether or not an IC-DISC will work, ask the following questions:

- Do you have any transactions outside of the U.S.?
- Do you use overseas distribution?
- Does your product cross any borders?
- Are you generating operating income?

If the answer to any of these questions is yes, an IC-DISC could be a valuable tax-savings vehicle for your business. ■

An IC-DISC can be used as a deferral tool to leverage a company's cost of capital.