

# IC-DISC: A DISCount for the Exporting U.S. Manufacturer

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**A** fairly intricate, but permanent tax break for certain shareholders of domestic manufacturing companies with foreign exports is the IC-DISC. An IC-DISC, or Interest Charge Domestic International Sales Corporation, is a domestic corporation that is formed to “facilitate” the export abroad of U.S. manufactured products as well as certain services. This article will discuss several of the most common scenarios and benefits of the IC-DISC. Keep in mind that if your fact pattern does not exactly match this discussion, there may still be benefits of an IC-DISC available.

## Tax Benefits of an IC-DISC

An IC-DISC works by paying a deductible commission from the exporting operating company to the qualified IC-DISC company. The commission is calculated in one of three statutorily defined ways, with the two most common (and simplest) being:

- 4 percent of the qualified export receipts, or
- 50 percent of the taxable income from qualified export receipts.<sup>1</sup>

The commission payment from the operating company to the IC-DISC is an ordinary deduction, and the dividend paid by the IC-DISC is afforded long-term capital gain treatment to the shareholders of the IC-DISC when actually or deemed distributed.<sup>2</sup> In other words, the commission deduction is worth up to 45.6 percent in tax savings (assuming the highest federal income tax rate of 39.6 percent plus Missouri income tax rate of 6 percent), while the IC-DISC income would be taxed at a lower rate of 29.8 percent (23.8 percent federal plus 6 percent Missouri). That is a permanent tax savings of 15.8 percent on the commission payment.

This reduction in tax rates is particularly beneficial to S corporation and partnership shareholders (as well as closely-held C corporation shareholders) by taking advantage of the lower capital gain rates for individuals. However, a non-closely held C corporation can take advantage of an IC-DISC structure by deferring the payment of income taxes on accumulated earnings of the IC-DISC that have not been distributed.

The following is an example of the tax savings due to the tax rate differential available to S corporation and partnership structures:

Example:	Without IC-DISC	With IC-DISC	SAVINGS
Export Sales	750,000	750,000	
COGS	600,000	600,000	
Net Profit	150,000	150,000	
IC-DISC Commission		75,000	
Taxable Income	150,000	75,000	
Tax Rate	39.6%	39.6%	
Partner Level Tax	59,400	29,700	29,700
Dividend to S/Hs	0	75,000	
Tax Rate	23.8%	23.8%	
S/H Level Tax	0	17,850	(17,850)
Total Tax	59,400	47,550	11,850

Although the tax rate differential mentioned above is clearly a nice benefit of the IC-DISC structure, deferral of payment of income taxes on earnings of the IC-DISC is another.

## The Interest Charge

As an IC-DISC receives commission income, it does not need to immediately turn around and distribute those earnings as a dividend. In fact, subject to certain restrictions, an IC-DISC can accumulate earnings for years before it pays any dividends to its shareholders.<sup>3</sup> What that means is that an operating company can receive a current deduction for commissions paid to the IC-DISC, but no one pays income taxes on the earnings of the IC-DISC until distributed—potentially even years later.

If this deferral benefit is chosen, an interest charge must be paid annually by the shareholders of the IC-DISC. The interest charge is based on the “base period t-bill rate,”<sup>4</sup> which then must be multiplied by two other factors.<sup>5</sup> The base period t-bill rate for 2014 is .001100604.<sup>6</sup> Namely, anything within reason multiplied by the 2014 base period t-bill rate is going to be a relatively small amount.

For example, the maximum 2014 interest charge for deferring income taxes on \$100,000 of DISC earnings is less than \$30.<sup>7</sup> Continuing this example, an operating company could calculate and pay a commission to an IC-DISC on Dec. 31, 2014, and receive an ordinary deduction on its 2014 tax return. Then the IC-DISC could “defer” payment of its income as a dividend until Jan. 2, 2015, thus allowing any individual shareholder(s) of the IC-DISC from recognizing the \$100,000 as a dividend

until they file their 2015 tax return. Basically this allows the individual IC-DISC shareholder(s) to have the use of \$100,000 for more than a year, and not paying income tax on that money until April 15, 2016—all for an interest charge of less than \$30!<sup>8</sup>

After recognizing that there are significant tax benefits to an IC-DISC structure, companies must make sure that they meet the statutory requirements.

## Requirements of an IC-DISC

First, the operating company must have qualified export receipts. In their most basic form, qualified export receipts are sales of property manufactured, produced or grown in the United States for direct use or consumption outside the United States. There are some limitations to this definition; for example, the fair market value of the U.S. manufactured property must not contain more than 50 percent imported articles.<sup>9</sup> Certain services are also included in the definition of qualified export receipts and thus available for IC-DISC benefits, including certain engineering or architectural services performed in the United States for construction projects located outside the United States.<sup>10</sup>

Second, if a company meets the qualified export receipts test, a separate corporation must be incorporated under the laws of any state in the United States. This new corporation may be incorporated:

- As a subsidiary of the operating company;
- By the shareholders of the operating company;
- By management of the operating company; or
- By almost anyone who can take advantage of the tax rate differential.

As you can see, the ownership of the IC-DISC is fairly flexible and may be used as a wealth-transferring mechanism, incentive for management, or simply to reduce the operating company shareholder's tax burden.

Third, administratively, the newly formed IC-DISC company must (subject to applicable state laws):

- Elect to be treated as an IC-DISC (Form 4876-A);
- File annual tax returns (Form 1120-IC-DISC);
- Maintain separate books and records;
- Have no more than one class of stock of which the par value of any stock outstanding must be at least \$2,500 on each day of the taxable year.<sup>11</sup>

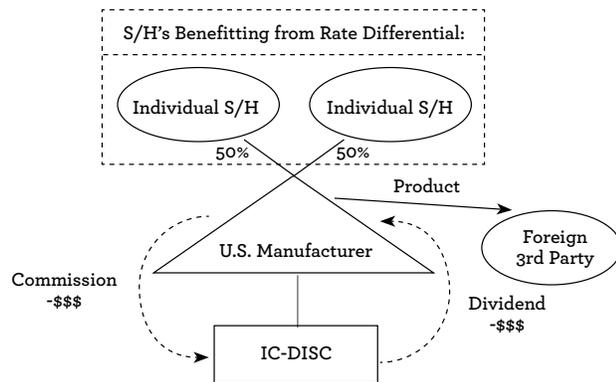
Fourth, paperwork should be drafted that establishes the relationship between the IC-DISC and the operating company. For example, a common document that should be executed is a Commission Agreement, which establishes that the IC-DISC is entitled to a commission on the operating company's qualified export receipts.

Finally, it should be noted that there does not need to be a fundamental change in your business. In its simplest form, an IC-DISC does not need its own employees, does not need office space and does not have to actually participate in the soliciting, negotiating or concluding

of any sales contract or perform any economic functions to earn a commission.<sup>12</sup> In fact, after formation and proper paperwork, the IC-DISC doesn't need to do anything except have a bank account, keep separate books and records, and cash commission checks and cut dividend checks. Keep in mind the point of the IC-DISC is a legislatively approved tax benefit to incentivize companies to manufacture products in the United States and sell outside of the United States.<sup>13</sup>

## Structure

This is a sample chart of what an IC-DISC structure would look like:



## Conclusion

At a high level, creating the IC-DISC is just piecing together facts and preparing paperwork. Through recognizing the proper scenario, correctly setting up the IC-DISC, abiding by the requirements and analyzing what ensures the largest tax savings for the taxpayer, the IC-DISC is an intricate but motivational tool for those ready and willing to use it.

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1. IRC §994. Unless otherwise specified, all section references are to the Internal Revenue Code of 1986 (IRC) or the regulations thereunder.
2. A qualified IC-DISC is itself not subject to corporate income taxes. §991.
3. §995.
4. §995(f)(4).
5. The two other factors that are multiplied by the base period t-bill rate are deferred DISC income under §995(f)(3) and the shareholder's DISC-related deferred tax liability under §995(f)(2).
6. See 2014 Form 8404. [www.irs.gov/pub/irs-pdf/f8404.pdf](http://www.irs.gov/pub/irs-pdf/f8404.pdf).
7. \$100,000 x 23.8 percent (maximum federal tax rate on qualified dividends) x 0.1100604 percent (2014 t-bill rate) = interest charge of \$27.
8. We assume the shareholder is an Exception 1, estimated taxpayer. This example also assumes that deferred DISC income is \$100,000.
9. §993(c)(1)(C).
10. §993(a)(1)(G).
11. See §992 for other requirements of an IC-DISC.
12. See the IRS IC-DISC Audit Guide located here: [www.irs.gov/Businesses/International-Businesses/IC-DISC-Audit-Guide](http://www.irs.gov/Businesses/International-Businesses/IC-DISC-Audit-Guide).
13. Note that the IRS IC-DISC Audit Guide acknowledges that on its surface, the IC-DISC appears to violate the general rules relating to corporate substance.