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IC-DISC

Interest Charge - Domestic International Sales Corporations

Permanent tax savings and more for owner-managed exporting businesses

Introduction

Under economic pressure from the World Trade Organization (WTO), Congress has repealed a foreign-trade incentive known as the extraterritorial income exclusion (ETI). The ETI exclusion is one of two legally designated benefits designed to reduce the burden of double taxation — domestic and foreign — on exports of U.S.- manufactured products and export-related services.

Why an IC-DISC is a smart choice now

Although ETI exclusion repeal will create a tax-savings void for some exporters, there is 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
- 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 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 IC-DISC may soon be the only remaining tax-savings opportunity. But fortunately, it's better than ever – and a smart choice for your business.

The IC-DISC structure

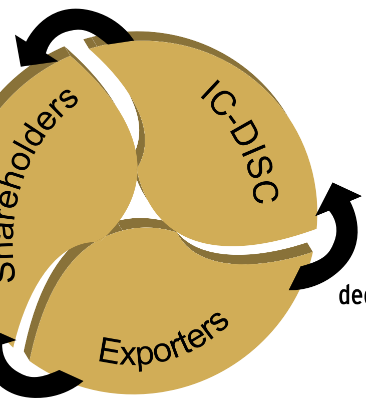
The IC-DISC is a "paper" entity utilized as a tax-savings vehicle. It does not require corporate substance or form, office space, employees or tangible assets. It simply serves as a conduit for export tax savings.

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

This diagram illustrates the structure and operation of an IC-DISC:



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. Some of the advantages and benefits provided by an IC-DISC are described below.

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.

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			
ID-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 shareholders; 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.

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.

For additional information, contact:

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