

SHOULD YOU CONSIDER AN INTEREST CHARGE DOMESTIC INTERNATIONAL SALES CORPORATION (IC-DISC)?

MP&S TAX ALERT
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TABLE OF CONTENTS

OVERVIEW	2
IC-DISC OFFERS TAX BREAKS FOR EXPORTERS AND OTHERS	3
WHAT IS AN IC-DISC?	4
HOW DOES AN IC-DISC REDUCE TAXES?	5
AN IC-DISC IN ACTION	6
OTHER BENEFITS	7
ACT NOW	8
ABOUT THE MP&S TAX PRACTICE	9

Setting up and operating an interest charge domestic international sales corporation (IC-DISC) can reduce the tax rate on qualifying export sales by up to 20 percentage points. An IC-DISC's tax-savings power is derived from the current 15% tax rate on qualified dividends. Businesses that could benefit include **companies that earn significant income from exporting goods, including software, or from engineering or architectural services on foreign construction projects**. If your company falls into one of these categories, you should consider creating an IC-DISC sooner rather than later because, without additional Congressional action, ***this tax rate applies only through 2012***.

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IC-DISC OFFERS TAX BREAKS FOR EXPORTERS AND OTHERS

If your closely held company earns significant income from exporting — or from engineering or architectural services on foreign construction projects — consider forming an interest charge domestic international sales corporation (IC-DISC). An IC-DISC is relatively inexpensive to set up and operate, and it can reduce your tax rate on qualifying sales by up to 20 percentage points.

To make the most of this strategy, it's a good idea to act soon. The IC-DISC's tax-saving power is derived from the favorable 15% tax rate on qualified dividends, which Congress recently extended — but only through 2012.

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WHAT IS AN IC-DISC?

An IC-DISC is a tax-exempt, domestic “paper” corporation set up to receive commissions on your company’s export sales. It must have its own bank account, keep separate accounting record and file its own U.S. tax returns. An IC-DISC need not have an office, employees or tangible assets, nor is it required to perform any services.

An IC-DISC reduces your tax liability by converting a portion of your export income, which is taxable at ordinary income rates as high as 35%, into qualified dividends generally taxed at 15%.

To qualify as an IC-DISC, a corporation must:

- Be incorporated in one of the 50 states or in the District of Columbia,
- File an election with the IRS to be treated as an IC-DISC for federal tax purposes,
- Maintain a minimum capitalization of \$2,500,
- Have a single class of stock, and
- Meet a qualified export receipts test and a qualified export assets test.

The last requirement means that at least 95% of an IC-DISC’s gross receipts and assets must be related to the export of property whose value is at least 50% attributable to U.S.-produced content. Engineering and architectural services related to construction projects outside the U.S. may also generate qualified export receipts.

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HOW DOES AN IC-DISC REDUCE TAXES?

Your company pays tax-deductible commissions to the IC-DISC up to the greater of 1) 4% of your company's gross receipts from qualified exports or 2) 50% of its net income from qualified exports. Because your company's taxable income is reduced by the amount of the commissions, ordinary income tax on those amounts is avoided.

The IC-DISC, as a tax-exempt entity, pays no tax on the commissions. When the IC-DISC distributes its income to shareholders, they're taxed at the qualified dividend rate. The qualified dividend rate is available only to individuals; thus, you'll need to structure the IC-DISC so that dividend payments are received by individuals.

If your company is a pass-through entity — such as a partnership, S corporation or LLC — you can form an IC-DISC as a subsidiary. Dividends the IC-DISC distributes to your company will be passed through to individual shareholders and qualify for the 15% rate.

If your company is a C corporation, however, you'll need to have the corporation's individual shareholders form the IC-DISC. If you set up the IC-DISC as a subsidiary of a C corporation, the dividends will be paid to the corporation and taxed as ordinary income.

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AN IC-DISC IN ACTION

Let's assume an S corporation has \$20 million in qualifying export sales and \$5 million in net income on those sales. If the company has an IC-DISC subsidiary, it can pay the IC-DISC commissions up to the greater of 50% of its export net income or 4% of its export gross receipts. In this case, the maximum commission is 50% of net income, or \$2.5 million.

The following calculation shows how the owners can save a combined \$500,000 in federal income taxes:

Without IC-DISC:

Net income	\$5,000,000
Tax rate	35%
Tax	<u>\$1,750,000</u>

With IC-DISC:

Net income	\$5,000,000
Commissions	<u>(2,500,000)</u>
Net income after commissions	\$2,500,000
Tax rate	35%
Tax	\$ 875,000

Commissions paid out as dividends	\$2,500,000
Tax rate	15%
Tax	<u>\$ 375,000</u>

Total tax	<u>\$1,250,000</u>
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Note: The example assumes that the IC-DISC distributes all of its income and that each of the company's shareholders is an individual in the 35% tax bracket.

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OTHER BENEFITS

Although an IC-DISC isn't *required* to perform any services, having it do so may enhance its benefits. Services might include promoting your company's export activities or purchasing receivables from your company at a discount ("factoring"). Just like commissions, income from these services can be charged to the operating company and can be distributed to shareholders at the qualified dividend tax rate.

It's also possible to use an IC-DISC as an estate planning tool. There's no requirement that an IC-DISC's shareholders be the same as the exporter's shareholders or that they own their shares in the same proportions. By giving IC-DISC shares to your children or other family members, you may be able to shift some of the income so it will be taxed at the 0% qualified dividend rate — which through 2012 applies to taxpayers in the two lowest ordinary-income tax brackets. (Bear in mind that there may be gift tax implications. But with the gift tax exemption at \$5 million for 2011 and 2012, this may be less of a concern. Also, beware of the "kiddie" tax.)

Finally, you can *defer* tax on up to \$10 million per year in commissions that are left in the IC-DISC by making modest interest payments to the IRS. These interest charges (the "IC" in IC-DISC) are tied to Treasury bill rates, which, in recent months, have been only a fraction of 1%.

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ACT NOW

An IC-DISC's tax benefits aren't retroactive — in other words, these benefits are available only for export sales made after the IC-DISC is established. And with the 15% qualified dividend rate set to expire at the end of 2012, the sooner you act, the greater your tax savings. If this favorable rate does expire, dividends will once again be taxed as ordinary income, eliminating the IC-DISC's ability to reduce your tax rate.

Of course, Congress might decide to extend the qualified dividend rate beyond 2012. But even if it doesn't, IC-DISCs will continue to provide an opportunity to shift income to loved ones in lower income tax brackets (taking advantage of the difference between ordinary-income tax rates rather than qualified dividend rates), as well as to *defer* taxes on export sales.

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ABOUT THE MP&S TAX PRACTICE

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