Country Focus

UNITED STATES

Contributed by Curtis Best, Marks Paneth LLP

Email: cbest@markspaneth.com

Interest-charge domestic international sales corporations: A powerful tax savings opportunity for export companies

IC-DISCs (interest-charge domestic international sales corporations) were once thought of as uninspiring, and not particularly efficient, tax deferral vehicles. They were originally created by the government as a way to assist US-based corporations that focused on foreign sales and exports.

In fact, regulators at that time even conceded that IC-DISCs were not really tax shelters at all, nor were they considered as listed or reportable transactions. As a result, IC-DISCs were largely marginalised as a tax-saving tool; overlooked at best and, if noticed at all, regarded as ineffective and not worth the attention of serious investors.

However, IC-DISCs are now regarded as an effective tax-saving tool for companies exporting products. Companies can take advantage of IC-DISC tax benefits without any conditions to make changes to the way they conduct business.

The two main reasons for resurgence of interest in IC-DISCs are:

- The passage of the Jobs and Growth Tax Relief Reconciliation Act of 2003 – and its extension via the American Taxpayer Relief Act of 2012, which introduced reduced tax rates for exporters possessing qualified dividends.
- The impact of the ever-growing global economy, which, in combination with these legislative initiatives, transformed IC-DISCs into tax-saving instruments that encourage US businesses to expand into more promising international markets.

IC-DISCs – the smart choice for US exporters

For qualified US exporters, IC-DISCs offer federal income tax savings of nearly 16%. What's more, some of those savings can be further parlayed via deferment structures that have been at the core of the IC-DISC rules since they were first enacted by Congress in 1971.

As they currently stand, some of the advantages and benefits of IC-DISC include:

- An IC-DISC entity is wholly tax exempt; that is, it does *not* pay income tax.
- IC-DISC dividends paid to *individual* shareholders are regarded as qualified dividends and are therefore taxed at reduced capital gains tax rates.
- Commissions paid to an IC-DISC reduce taxable profit of related supplier corporations at ordinary rates.
- Permanent tax savings on export sales.
- Increased liquidity for shareholders or the business.
- The ability to leverage cost of capital.
- Opportunities to create management incentives.
- Can be used in estate planning and wealth transfer.

In retrospect, it would seem that IC-DISCs have greater resilience than many other export-related tax schemes. In fact, when the first DISC policy was introduced, it immediately brought condemnation from a variety of European countries; they alleged that it was a proscribed export subsidy and therefore contravened the General Agreement on Tariffs and Trade (GATT).

However, in 1985, the DISC legislation was amended to add an interest charge on shareholders for taxes deferred under the original DISC provisions, which diminished the benefits but appeased Europe. The result was that Congress enacted a new export tax incentive with better benefits than the IC-DISC – the Foreign Sales Corporation (FSC) – which was later successfully contested by the World Trade Organization (WTO) and repealed in 2002. Congress again reacted to replace the FSC with the Extraterritorial Income Exclusion (ETI), but the WTO successfully challenged the ETI and it was repealed in 2004.

How IC-DISCs are structured

A conventional arrangement of an IC-DISC requires a variety of internal calculations and a certain degree of support, but these have no effect whatsoever on the ways in which the exporting company interacts, or otherwise manages its relations, with clients or vendors.

From a management point of view, the actual creation requires very little in the way of governance arrangements. All it entails is the establishment of an onshore corporation, legal agreements that formalise the relationship of the IC-DISC to the exporter, and submission to the Internal Revenue Service (IRS) of the organisation's tax election and all of its yearly tax returns.

Not only is an IC-DISC easy to set up, but also as a commission DISC it is not required to produce customer invoices, employ any staff, or even lease office space. Also, most IC-DISC arrangements are undetectable to all but the principals of a company, and yet can legally save that company substantial amounts of money. Finally, there are no restrictions on who can own an IC-DISC. In fact, IC-DISC shareholders can be partnerships, limited liability companies, individuals, C corporations, S corporations, trusts, IRAs or any permutation of the former.

For the right taxpayer, a DISC can also be an estate planning tool. Recently, the US Court of Appeals for the Sixth Circuit rejected the IRS's application of the substance-over-form doctrine where a Roth IRA owned a DISC, *Summa Holdings, Inc. v. Commissioner*, 2017 BL 46929, 848 F.3d 779 (6th Cir. 2017). In *Summa*, a family owned Summa Holdings, a group of wholly owned manufacturing companies. Summa Holdings established a DISC, which was owned, indirectly, by Roth individual retirement accounts for the benefit of younger family members. Summa Holdings paid the DISC commissions and took a tax deduction. The DISC paid those commissions as dividends to the Roth IRAs and were not subject to income tax.

One advantage is that foreign individuals and non-US companies can be IC-DISC shareholders, although the taxation of IC-DISC dividends paid to foreign owners is subject to different rules than those that apply to US citizens and business entities. If a foreign-owned company is exporting qualified export property, a buy-sell DISC may be established to significantly reduce or eliminate US income tax and potentially a tax treaty can reduce the withholding tax rate on dividends to ≤15%. By using a US company for the export activities, EXIM bank financing may be available to the foreign shareholder. Careful planning is required for foreign shareholders in vetting and establishing a DISC.

How IC-DISCs function

The operations of IC-DISCs are relatively straightforward. First an exporting company or its shareholders create a domestic corporation that will ultimately become the IC-DISC.

Once it is operating, the exporting company pays the IC-DISC a commission based on the profits of the export sales. The size of the commission is governed by precise legal regulations. The exporting company is then free to deduct the commissions payable to the IC-DISC from its regular income, which is then taxed at the maximum federal rate of 39.6%.

However, not all types of export sale are eligible for inclusion in a DISC arrangement. To qualify, exports must be:

- Manufactured, produced, grown or extracted in the USA by a person other than a DISC;
- Held primarily for sale, lease or rental for direct use, consumption or disposition outside the USA; and
- ≤50% of fair market value of the export property can be attributable to foreign content.

The eligibility requirements of a DISC are more extensive than is commonly assumed and can include direct and indirect exporters, software licensing companies, and even architectural and engineering design companies. In fact, many of these sorts of company are simply unaware that they are eligible for DISC status – and so cannot take advantage of the many tax advantages they offer.

In some instances, an IC-DISC can even be used as a tool for estate planning or as an incentive to employees.

However, IC-DISC constitutes a special class of tax-exempt organisation: it doesn't pay any federal income tax on the commissions it accepts from the exporting company, and individual shareholders or trusts only pay federal income tax on dividends at a maximum rate of 23.8% (15–20% capital gains rate + 3.8% Medicare tax).

Is an IC-DISC right for your business?

Depending on your business objectives, IC-DISCs can be utilised in a variety of ways to help you realise those goals. Deployed correctly, an IC-DISC can achieve some of the benefits outlined below.

Produce ongoing tax savings

An exporting company will pay taxes of 39.6% on its ordinary income, but not on the commission it pays to the IC-DISC. Current tax regulations have the commission rate at the greater of either 4% of gross receipts (which is restricted to 100% of net income from the export sale), or 50% of taxable income from export sales.

Since IC-DISCs are tax exempt, only distributions to shareholders are actually taxed – at a maximum rate of 23.8% (federal).

Provide C corporations with tax-deductible dividends

C corporations can also benefit from IC-DISC arrangements, since they are eligible for long-term tax savings for disbursements that might otherwise be categorised as dividends. If a C corporation can generate adequate profits from its exports, then a sister IC-DISC can earn a commission equal to the payments otherwise set aside as dividends.

This means that what would normally be regarded as a non-deductible dividend payment can be turned into a commission expense, which is tax deductible. Also keep in mind that shareholders who receive dividend payments are taxed at the same rate, regardless of whether the disbursement is issued by an IC-DISC or a C corporation.

Make capital costs lower

One little-known advantage to an IC-DISC arrangement is that an exporting company can leverage its capital costs by using it as a deferral tool. The fact is that not all of an IC-DISC's earnings must be dispersed to shareholders only; they can be transferred to the company via the savings generated by the lower tax rate that is applied to qualified dividends.

The method used is simplicity itself: an exporting firm is entitled to lend its accumulated IC-DISC earnings back to itself, for which it receives a note and interest in the form of a producer's loan. The company can then deduct the interest expense. Again, this is permissible because interest income is regarded as a dividend to the IC-DISC shareholders.

So, by ploughing its IC-DISC earnings back into the business the company secures additional tax savings and effectively lowers its capital costs. However, a company taking this route would be wise to consult their accountants and legal counsel first, since there are restrictions governing the size of a producer's loan and the uses to which it can be put.

Enhance liquidity

If the company – or an individual shareholder – wants to adjust or realign the degree of investment risk they are willing to tolerate, they can leverage their IC-DISC holdings to secure added liquidity. Cash obtained in this tax-advantaged way allows either the company or the shareholder to relocate their resources to better manage their investment risk profiles.

An added tax savings bonus

Finally, there is actually no bar to a company that wants to operate an IC-DISC and also claim the DPAD (Domestic Production Activities Deduction), which can potentially reduce a company's effective federal tax rate (by up to 3%) by claiming certain US-based production endeavours (under Section 199 of the Internal Revenue Code).