IC-DISCs: Structuring to Maximize Tax Benefits

By Robert J. Misey, Jr.

Robert J. Misey discusses the basics of Interest Charge Domestic International Sales Corporations (IC-DISCs) and explores a variety of sophisticated structures.

Wolters Kluwer

Many U.S. exporters are aware of the income tax benefits derived by exporting via an Interest Charge-Domestic International Sales Corporation (IC-DISC). If a passthrough entity, such as an S corporation or an LLC, forms an IC-DISC, the individual owners of the exporter can reduce their income tax by approximately 50 percent on a portion of their export profits. Although this flow-through exporter structure has become popular with the IC-DISC in the last 13 years, many other exotic structures can create tax savings on exports. The purpose of this article is to describe the basics of the IC-DISC before exploring a variety of sophisticated structures.

To achieve these benefits, (a) the owners of the exporter form an IC-DISC, (b) the exporter pays a tax-deductible commission to the IC-DISC, and (c) the IC-DISC pays a dividend to the owners of the IC-DISC.

To form an IC-DISC, the exporter or its owner will create a U.S. corporation with a single class of stock[1] that has a minimum par value of $2,500 and elects to be an IC-DISC within 90 days by filing a Form 4876-A.[2]

To prevent the stuffing of nonexport related activities in an IC-DISC, 95 percent of the IC-DISC's gross receipts must constitute qualified export receipts[3] and 95 percent of the assets of the IC-DISC must be qualified export assets.[4] Qualified export receipts include sales of export property, engineering or architectural services for construction projects abroad, and commissions thereon. Qualified export assets include temporary investments, export property, accounts receivable and loans to producers.

ROBERT J. MISEY, JR. is a Shareholder of the Business, International and Tax Departments of Reinhart Boerner Van Deuren s.c. in Milwaukee, Wisconsin. He previously worked with the IRS Chief Counsel (International) in Washington, D.C.

The Fundamentals of Simple Structuring

Pursuant to the Internal Revenue Code, an IC-DISC is a U.S. corporation that is not subject to the regular U.S. corporate income tax and, as a result, the

© 2016 R.J. MISEY, JR.

FIGURE 1.

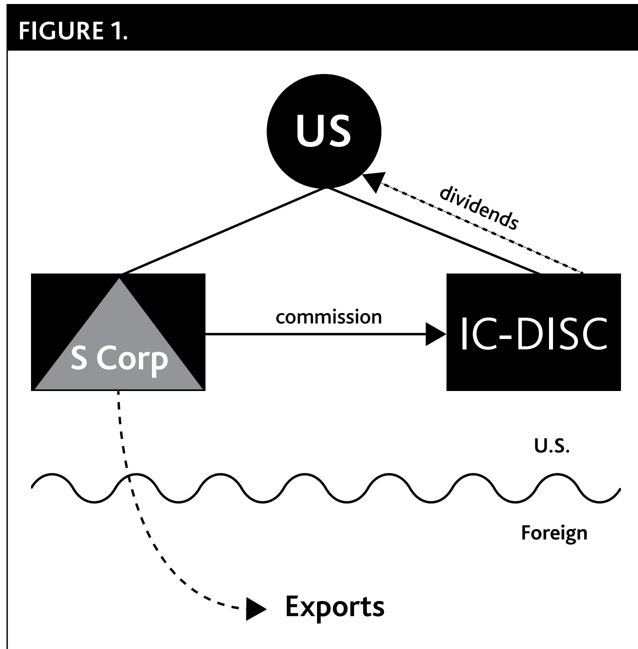
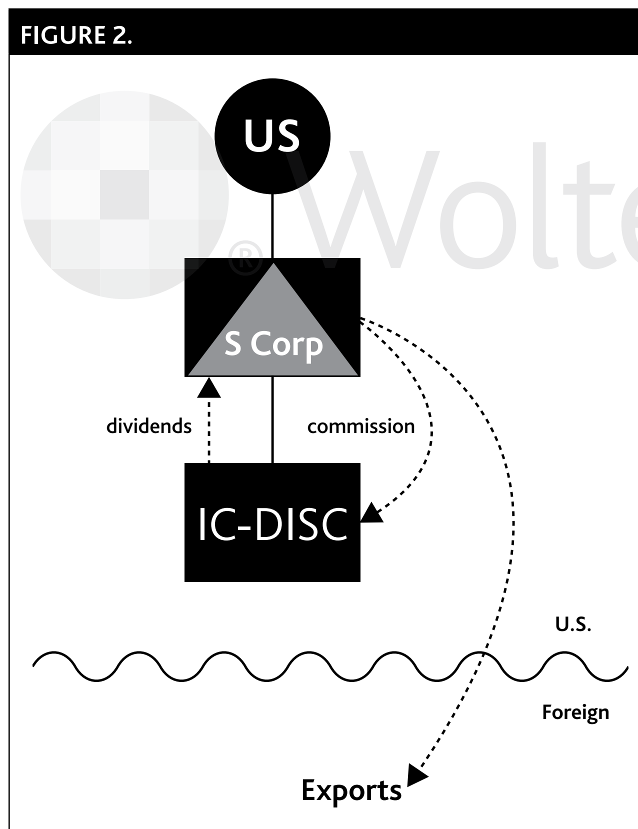


FIGURE 2.



IC-DISC does not pay income tax on the commission received[5] from the exporter. When the IC-DISC pays the dividend to the owners, the owners will pay income tax at a 20-percent rate. If the exporter is a flow-through entity, the reduction in income tax is 20 percentage points. In effect, the exporter is converting a 40-percent income tax[6] on income representing the amount of the commission to a 20-percent income tax.[7]

The larger the commission, the larger the income tax savings. The commission can be calculated using either four percent of gross export receipts or 50 percent of the pre-tax income from exports.[8] An exporter can use either method to achieve the greatest IC-DISC commission possible. The IC-DISC rules permit using different methods of paying commissions by different product lines, by recognized industry or trade usage, or even by transaction.

When net pre-tax margins exceed eight percent, the 50 percent of the pre-tax income from exports method provides a greater benefit—approximately $100,000 for every $1 million of pre-tax income from exports. However, if net pre-tax margins are below eight percent, the four percent of gross exports method produces the bigger benefit—approximately $8,000 for every $1 million of gross exports.

There are three requirements to qualify as export property[9]:

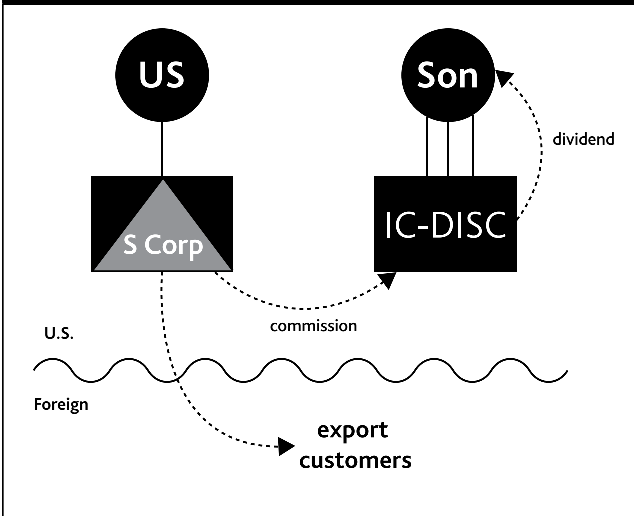
1. The property must be manufactured, produced, grown or extracted in the United States (but not by the IC-DISC). As a result, exported property could include traditionally U.S. manufactured product (*i.e.*, "widgets"), agricultural products, and even live animals, such as thoroughbreds.
2. The export property must have a maximum foreign content of 50 percent.
3. The export property must be held primarily for sale, consumption or disposition outside the United States. Sales to a U.S. customer, who subsequently exports the product without conducting manufacturing, qualify for the benefit, if the exporter can track those subsequent exports.

The federal income tax benefits are the same regardless of whether the IC-DISC creates a subsidiary of the flow-through entity or a brother-sister entity of the flow-through entity. In either scenario, the exporter will pay a commission that is deductible from income taxed at a top individual rate of approximately 40 percent and will result in a qualified dividend taxable to the exporter's owner at a rate of 20 percent.

For state and local tax purposes, it may be beneficial to have the IC-DISC as a brother-sister entity of the flow-through entity. (See Figure 1.)

On the other hand, if the exporter has some debt, the lender will typically prefer to have the IC-DISC as a subsidiary of the flow-through entity, such that the debt continues to be secured by the commission paid by the exporter. (See Figure 2.)

FIGURE 3.



Sophisticated Structures

Many owners of exporters would like to form an IC-DISC to be owned by their offspring as a means to move value out of the owner's estate. These structures depend on determining the value provided the offspring for gift tax purposes. Although many IC-DISCs are formed with $2,500, an old revenue ruling indicates that the amount of the gift is each payment of the commission from the exporter to the IC-DISC.[10] When issued, this revenue ruling was roundly criticized by practitioners and there are no reported cases precisely dealing with this issue. Furthermore, the IRS issued an IC-DISC Audit Guide that fails to mention the issue whatsoever. (See Figure 3.)

Instead of having their offspring as owners of an IC-DISC, the owner of an exporter may want to reward a long-time employee with shares in an IC-DISC. These may result in shares of the IC-DISC being owned by a sales manager who has been the driving force behind the exports and is a way to future motivate that sales manager for further exports. (See Figure 4.)

Although both of these sophisticated structures depict brother-sister entities, they also work as a parent-subsidiary structure.

Structuring for C Corporations

If the exporter is a C corporation, the income tax savings are approximately 28 percent—*in lieu* of a 35-percent corporate tax rate and a subsequent 20 percent individual income tax on any subsequent dividends, the only income tax would be the 20 percent qualified dividend rate on the commission from the IC-DISC to its owners.

FIGURE 4.

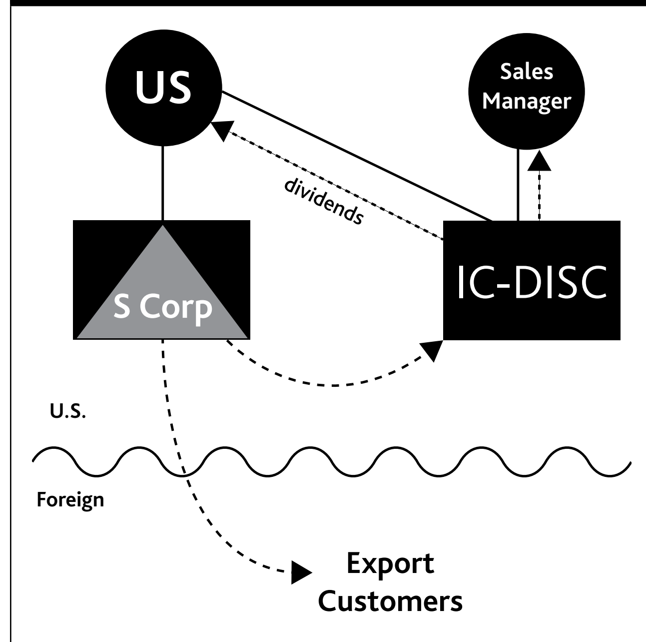
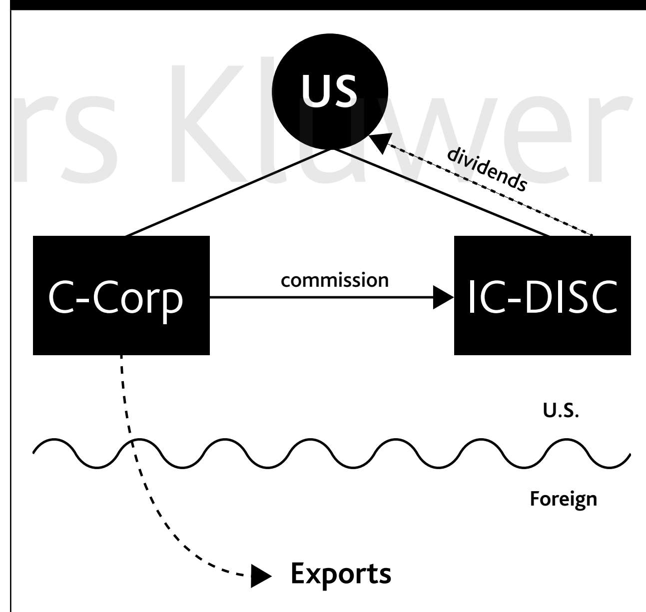


FIGURE 5.



However, an IC-DISC should not be a subsidiary of a C corporation because the IC-DISC dividend is not eligible for a dividends received deduction. As a result, the C corporation would pay tax on the IC-DISC dividend and, accordingly, lose the permanent tax savings. (See Figure 5.)

If a C corporation has many owners, the IC-DISC could be owned by a trust, whose beneficiaries would be the owners of a C corporation. The trust would be able to distribute the dividends to the beneficiaries/owners without

Wolters Kluwer

FIGURE 6.

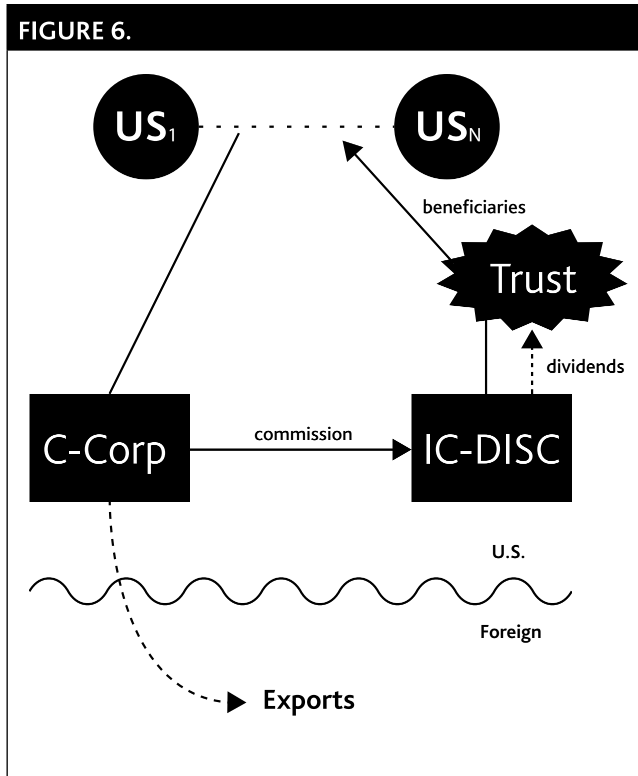
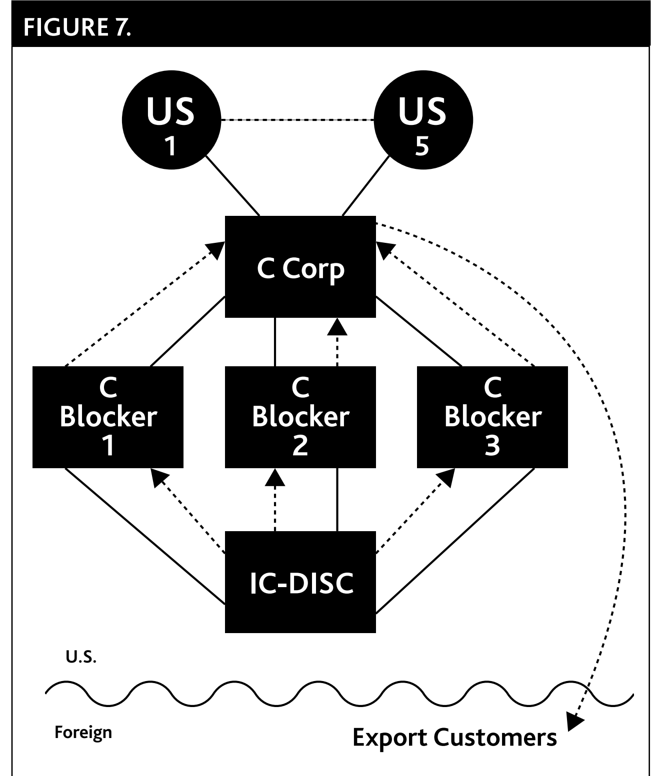


FIGURE 7.



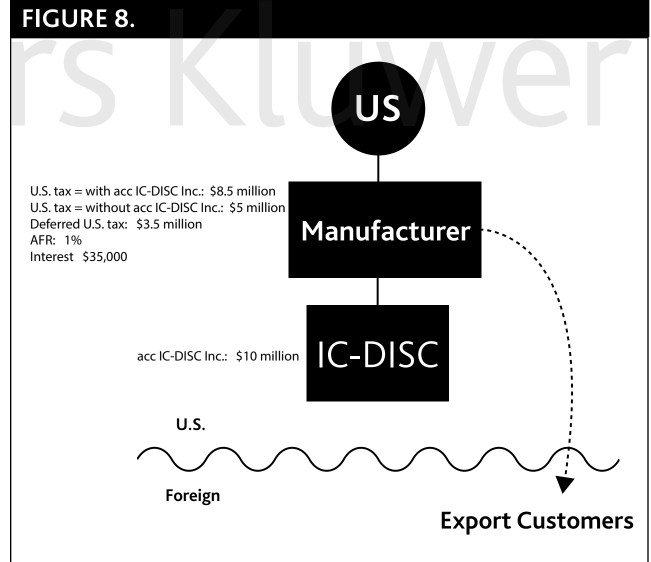
having to worry about constantly changing ownership of the exporting C corporation. (See Figure 6.)

Instead of forming a trust, the C corporation's U.S. owners could form an LLC to own the IC-DISC. However, drafting the operating agreement of the LLC to have substantial economic effect is typically more burdensome than drafting a trust arrangement.

Suppose, however, that due to business reasons, the IC-DISC cannot be a brother-sister entity of a C corporation. Although there is not a dividends received deduction from an IC-DISC to a C corporation, the C corporation could form various blocker corporations and choose not to treat them as part of a consolidated group.[11] The blockers will pay tax at lower marginal rates and they will be able to pay dividends to the C corporation that are entitled to a dividends received deduction. (See Figure 7.)

Even if a C corporation is not able to obtain any permanent tax savings by having an IC-DISC as a subsidiary, the opportunity for deferral may create benefits. This is because the interest rate charged an owner is merely the low annual federal rate on the amount of income tax that the owner would have had to pay with a distribution from the IC-DISC over the amount of income tax without a distribution from the IC-DISC.[12] If, for example, a C corporation would have income tax of $8.5 million without an IC-DISC compared to $5 million with an IC-DISC, the amount of the interest charge would be the AFR

FIGURE 8.



(assuming one percent) times the $3.5 million difference for $35,000. The C corporation's Treasurer should be able to find some use for the money that would be more productive than a one percent interest rate. (See Figure 8.)

Complex Structures

Many agricultural cooperatives have taken advantage of savings with an IC-DISC. Typically, these cooperatives

Wolters Kluwer

FIGURE 9.

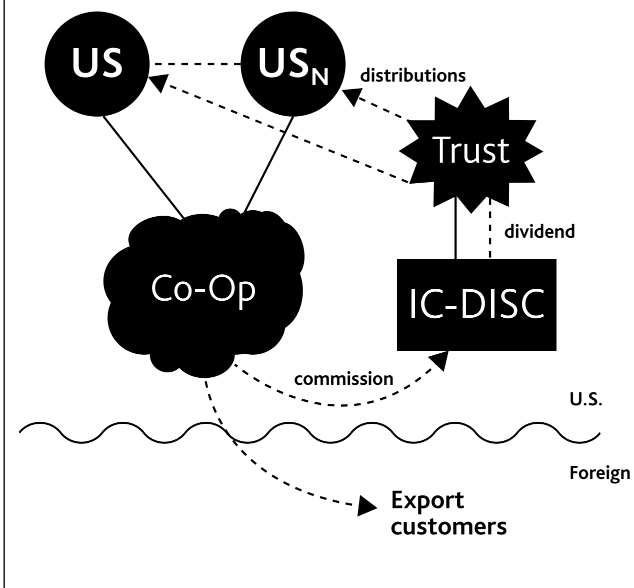
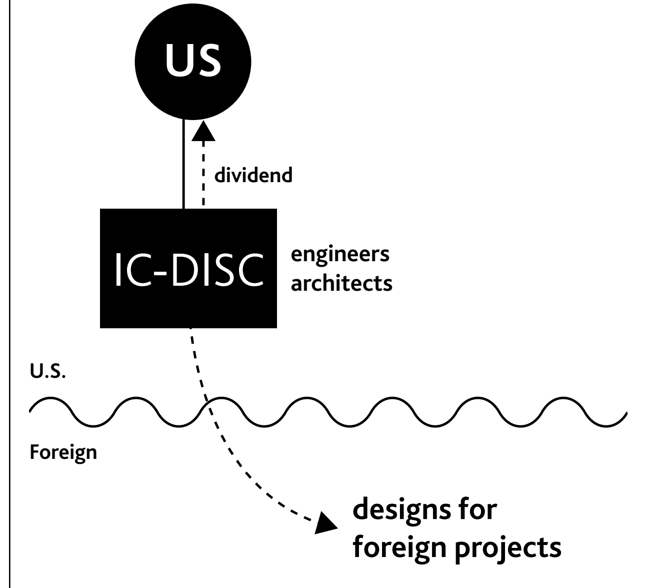


FIGURE 10.

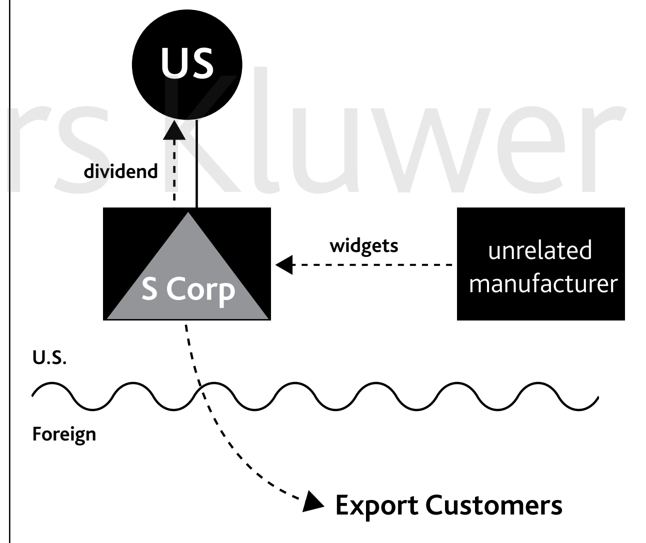


contribute their produce to the cooperative that exports the produce and distributes a patronage dividend to the individual farmers, which is taxed at a top marginal rate of approximately 40 percent.[13] Instead, the individual farmers can form an IC-DISC that a trust owns. The beneficiaries of the trust will be the individual farmers in whatever their patronage percentage was for a particular year. Again, this technique converts, in the amount of the commission, income taxed at approximately 40 percent (the patronage dividends) into qualified dividend income taxed at 20 percent. (See Figure 9.)

Recall that qualified export receipts include engineering or architectural services for construction projects abroad. Many architects or engineers have formed IC-DISCs as a simple structure and paid the maximum commission possible to obtain savings. However, the owners of these architectural engineering firms can achieve a bigger benefit by forming an IC-DISC that creates engineering or architectural designs for construction projects located abroad. By having these employees work for the IC-DISC when providing services for construction projects abroad, the firm can move more income to the IC-DISC and, in effect, pay tax at only 20 percent on the entire amount of the profit. (See Figure 10.)

Another play on only owning an IC-DISC includes a pure distributor. A pure distributor would purchase goods from an unrelated manufacturer and sell them to export customers. By only having the IC-DISC purchase from an unrelated party the products that are exported, this structure provides for an entire amount of profit on

FIGURE 11.



the distributed product incurring only a 20-percent rate of income tax. This structure only works for a distributor as an IC-DISC cannot manufacture the export property. (See Figure 11.)

Although an IC-DISC may not be the manufacturer of export property, the IC-DISC may purchase export property from a U.S. manufacturer instead of merely receiving a commission. This is an effective strategy if the exporter has a well-known brand name for quality products, but wants to produce an "off" brand under a different name, such that the "off" brand does not tarnish the established brand. (See Figure 12.)

Wolters Kluwer

FIGURE 12.

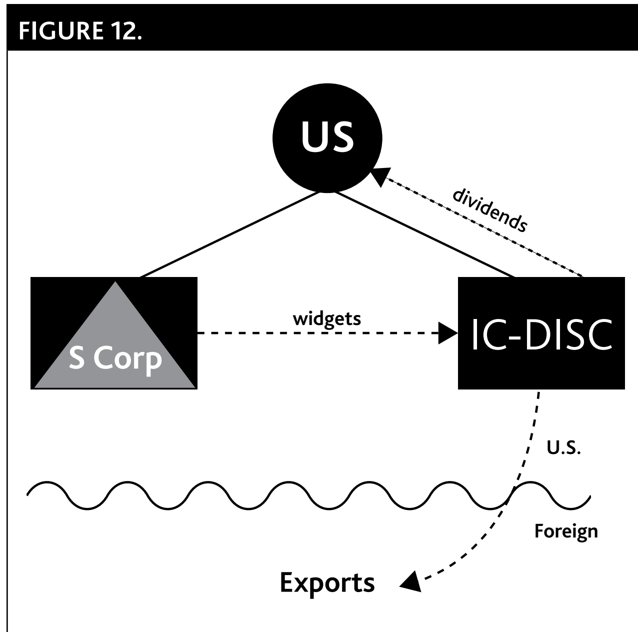
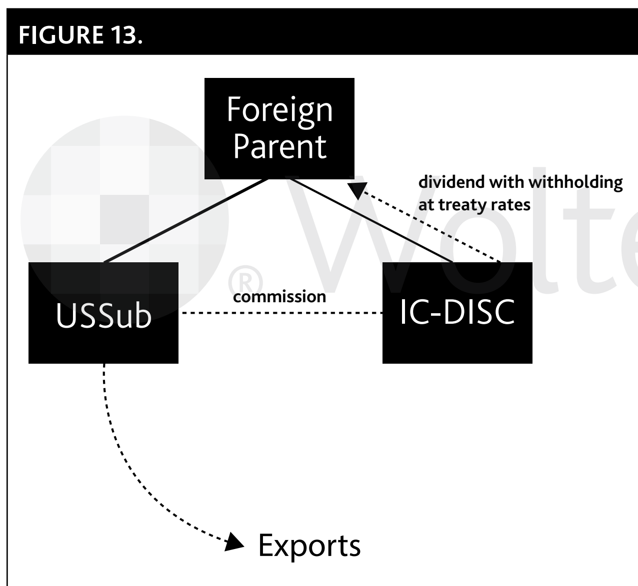


FIGURE 13.



A C corporation that is the U.S. subsidiary of a foreign parent may also take advantage of an IC-DISC. Assuming that the foreign parent is in a country that has recently entered a tax treaty with the United States, the foreign parent could form an IC-DISC as a brother-sister entity of the U.S. subsidiary. The U.S. subsidiary pays a deductible commission to the IC-DISC, which does not pay any tax. The IC-DISC subsequently distributes a dividend to the foreign parent at a reduced withholding rate while avoiding the U.S. corporate income tax on the amount of the commission. (See Figure 13.)

Conclusion

In addition to the simple structure described above, the other structures are more complex but provide income tax savings for a variety of businesses. Nevertheless, all the structures are effective only when implemented correctly, which requires the tax professional to:

1. incorporate the IC-DISC before the exports begin (waiting until December to form the IC-DISC will result in only December exports qualifying);
2. analyze the exports, which includes sales of products to (a) U.S. customers who ultimately export (without conducting further manufacturing) and (b) Canadian or Mexican customers that received shipment by ground transportation;
3. prepare a commission agreement between the IC-DISC and the exporter;
4. prepare and file the Form 4876-A that elects IC-DISC status within 90 days of incorporation; and
5. prepare a manual that provides the exporter with operating procedures, including a checklist/calendar to determine when the client should complete various activities.

ENDNOTES

1. Code Sec. 992(a)(1)(C).
2. Code Sec. 992(b).
3. Code Secs. 992(a)(1)(B) and 993(a).
4. Code Secs. 992(a)(1)(A) and 993(b).
5. Code Sec. 991(a)(1).
6. Code Sec. 1. The IRS has not promulgated guidance regarding whether the 3.8-percent net investment income tax of Code Sec. 1411 applies to dividends from an IC-DISC.
7. Code Sec. 1(h)(11).
8. Code Sec. 994(a).
9. Code Sec. 993(c).
10. Rev. Rul. 81-54, 1981-1 CB 476.
11. Code Secs. 1501 to 1502.
12. Code Sec. 995(f).
13. Code Sec. 1388(a).

This article is reprinted with the publisher's permission from the Taxes The Tax Magazine®, a monthly journal published by Wolters Kluwer. Copying or distribution without the publisher's permission is prohibited. To subscribe to the Taxes The Tax Magazine® or other Wolters Kluwer Journals please call 800 449 8114 or visit CCHGroup.com. All views expressed in the articles and columns are those of the author and not necessarily those of Wolters Kluwer.