

Tax Savings for Architects and Engineers with IC-DISCs

By Robert J. Misey, Jr.*

Robert J. Misey, Jr. examines how architectural and engineering firms that are performing services for projects outside the United States can take advantage of the Interest Charge-Domestic International Sales Corporation (“IC-DISC”).



With the increasing globalization of business, many architectural and engineering firms are performing services for projects outside the United States. However, only a few of these firms are taking advantage of the best federal tax benefit available for architects or engineers—the Interest Charge-Domestic International Sales Corporation (“IC-DISC”). Many architectural and engineering firms are missing the IC-DISC benefits that manufacturers have enjoyed for years.

By forming an IC-DISC, a firm can achieve income tax savings of at least 20%. To achieve these savings, the owners of the firm form an IC-DISC, the firm pays a commission to the IC-DISC, and the IC-DISC pays a qualified dividend to the owners of the IC-DISC (who also own the firm), resulting in income tax at the qualified dividend rate of only 20%.¹

An IC-DISC is not subject to the U.S. corporate income tax and, as result, does not pay tax on the commission received from the architectural or engineering firm. When the IC-DISC pays a dividend to the owners, the owners will pay income tax at a 20% rate.² If the architectural firm is a flow-through entity, such as an S corporation, partnership, or limited liability company, the reduction in income tax is 20 percentage points. In effect, the firm is converting an approximately 40% income tax on the amount of the commission³ to a 20% income tax. If the architectural or engineering firm is a C corporation, the income tax savings are even greater because the commission provides the additional benefit of removing the income from corporate tax, creating, in essence, a deductible dividend.⁴

The IC-DISC was designed as a means by which a U.S. exporter could borrow funds from the U.S. Treasury at a low interest rate. So if, and only if, the IC-DISC does not pay a dividend, the U.S. shareholder pays an interest charge

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on its IC-DISC-related deferred tax liability, which equals the difference between the shareholder's tax for the taxable year computed first with, and then without, the accumulated IC-DISC income of the shareholder that has been deferred over the years.⁵

In practice, the IC-DISC will distribute cash representing all of its income, rendering deferral and the interest charge inapplicable. Accordingly, because the rate of tax on qualified dividends is only 20%, individual owners of the IC-DISC should want to take a dividend immediately and not consider deferral.

An IC-DISC is not an S corporation or an LLC. An IC-DISC is a U.S. C corporation that has elected IC-DISC status by timely filing Form 4876-A⁶ and has a par value of at least \$2,500.⁷

The Tests to Qualify as an IC-DISC

To qualify as an IC-DISC, the U.S. corporation must pass both the qualified export receipts test and the qualified export assets test.

The qualified export receipts test states that 95% of the gross receipts of the IC-DISC must constitute qualified export receipts.⁸ Qualified export receipts include receipts for performing engineering or architectural services for construction projects located outside the United States and commissions thereon. Although the projects must be located outside the United States, the services may be performed either inside or outside the United States:

Example 1. Uncle Sam wholly owns ArchCo, an S corporation that designs foreign buildings. Due to a high demand abroad for U.S. designs, Uncle Sam forms an IC-DISC whose only activity results in receiving commissions on \$8 million of qualified export receipts by USAco. Because 100% of the IC-DISC's gross receipts constitute qualified export receipts (commissions on the receipts from the foreign project), the IC-DISC satisfies the qualified export receipts test (see Figure 1).

The qualified export assets test states that 95% of the assets of the corporation must be qualified export assets.⁹ Qualified export assets include accounts receivable on export receipts, temporary investments (*e.g.*, working capital), and assets used in connection with performing engineering and architectural services (either inside or outside the United States) for construction projects located outside the United States.

Example 2. Uncle Sam wholly owns ArchCo, an S corporation that designs foreign buildings. Uncle Sam forms an IC-DISC that has \$3,000 of working capital at the beginning and at the end of the year (any commissions received were distributed as dividends before the end of the year). Because the working capital constitutes qualified export assets, 100% of the IC-DISC's assets constitute qualified export assets. Consequently, the IC-DISC passes the qualified export assets test (see Figure 2).

Both the qualified export receipts and qualified export asset tests should be passed if the IC-DISC only receives a commission and distributes the cash representing the commission to its owners by the end of the year.¹⁰

FIGURE 1.

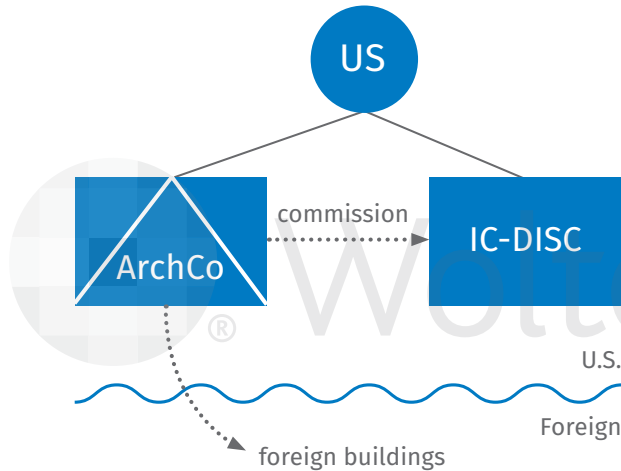
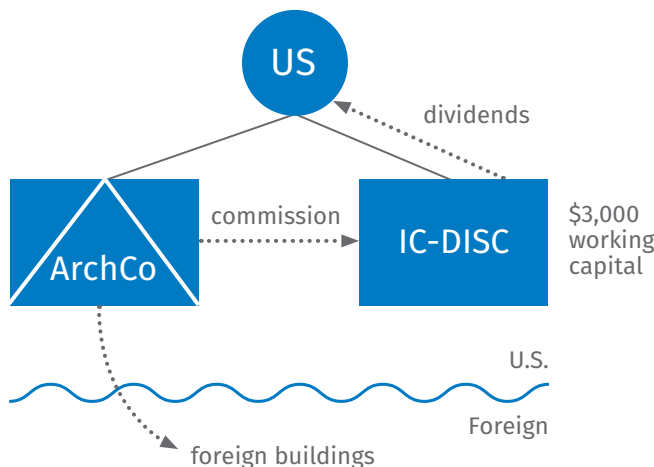


FIGURE 2.



The Commission

A commission is payable to the IC-DISC on income produced from performing architectural or engineering services (regardless of where performed) for construction projects located abroad.¹¹ Qualifying architectural services include consultation, planning, aesthetic and structural designs, drawings and specifications, and responsible supervision of construction.¹² Qualifying engineering services include consultation, investigation, evaluation, planning, design, or responsible supervision of construction to ensure compliance with plans, specifications, and designs.¹³

The commission should be an amount constituting either 4% of the gross receipts from the foreign project or 50% of the taxable income from the foreign project.¹⁴ The architectural or engineering firm can use either method to determine the biggest commission on each project abroad.

As a simple rule of thumb, the gross receipts method provides the largest commission when the foreign project has a net operating margin of less than 8% (producing a benefit of approximately \$8,000 for every \$1 million of gross receipts). On the other hand, the taxable income method results in the largest commission when a foreign project has a net operating margin of greater than 8% (producing an income tax benefit of approximately \$100,000 for every \$1 million of taxable income).

Example 3. Archie owns ArchCo, an S corporation. ArchCo earns \$6 million of gross receipts for designs it has created for building projects in Europe. Using 4% of the gross receipts method, ArchCo will deduct the commission paid of \$240,000, resulting in an income tax reduction of \$96,000 (40% of \$240,000). If ArchCo's IC-DISC distributes the cash representing this commission as a dividend to Archie, Archie would pay U.S. income tax of \$48,000 (\$240,000 at the 20% income tax rate on the qualified dividend). As a result, the impact of the 4% of gross receipts method combined with the 20% qualified dividend income tax rate is an income tax savings of \$48,000 (\$96,000 less \$48,000) (see Figure 3).

Example 4. ArchCo earns \$6 million of gross receipts for designs it has created for projects in Europe while incurring \$5 million of related operating expenses for taxable income of \$1 million. Using the 50% of taxable income method, ArchCo will

deduct the commission paid of \$500,000, resulting in an income tax reduction of \$200,000 (40% of \$500,000). If ArchCo's IC-DISC distributes the cash representing this commission as a dividend to Archie, Archie would pay U.S. income tax of \$100,000 (\$500,000 at the 20% income tax rate on the qualified dividend). As a result, the impact of the 50% of taxable income method combined with the 20% qualified dividend income tax rate is an income tax savings of \$100,000 (\$200,000 less \$100,000) (see Figure 4).

FIGURE 3.

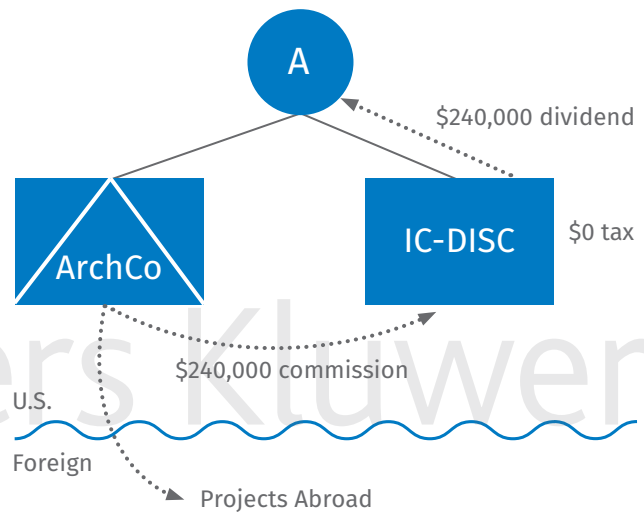


FIGURE 4.

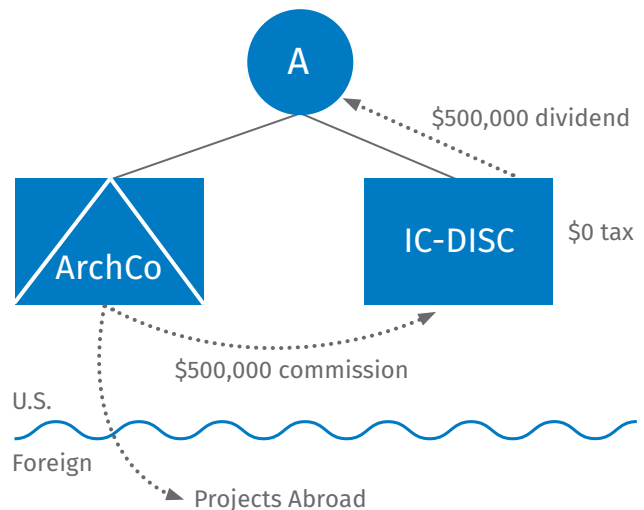


TABLE 1.

	Gross receipts	Taxable income	Net pre-tax margin
Skyscraper	\$ 5,000,000	\$1,000,000	20%
Shopping Mall	\$ 5,000,000	\$ 200,000	4%
Total export receipts	<u>\$10,000,000</u>	<u>\$1,200,000</u>	12%

FIGURE 5.

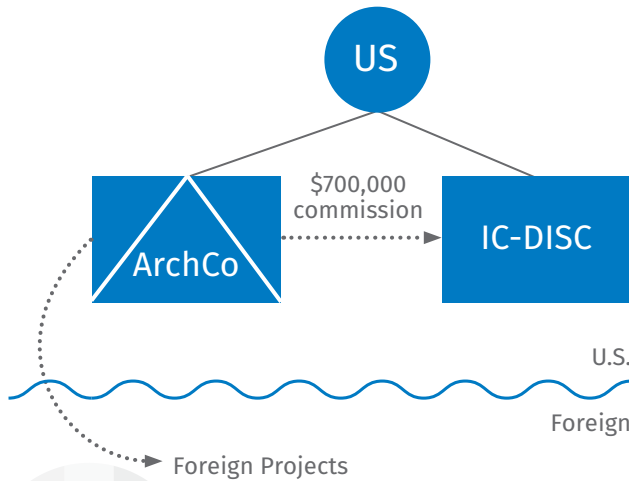
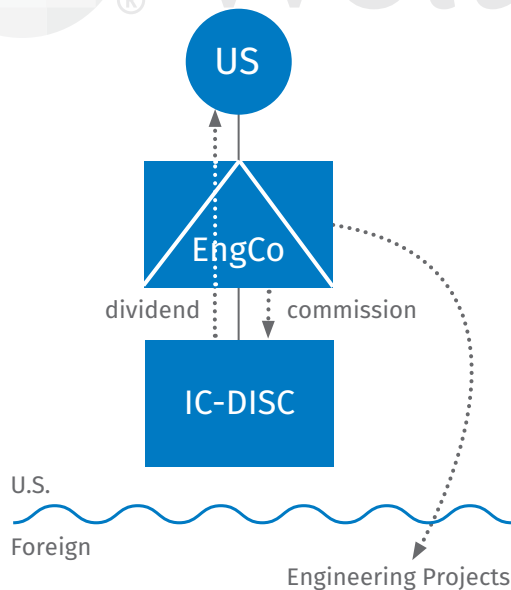


FIGURE 6.



An exporter can use either method to achieve the greatest IC-DISC commission possible. The IC-DISC rules permit the use of different methods to different projects determined on a transaction-by-transaction basis.¹⁵ More

importantly, determining the commission on a transaction-by-transaction basis permits the architect or engineer to maximize the IC-DISC's commission by separating a high-margin project from a low-margin project.

Example 5. ArchCo, an S corporation, designs a foreign skyscraper and a foreign shopping mall. The annual gross receipts and combined taxable income from these two projects are as follows (see Table 1 and Figure 5).

By separating the determination of a commission for each project, ArchCo can use the 50% of taxable income method for the design of the skyscraper, which results in a commission of \$500,000 [50% of \$1,000,000] to the IC-DISC. At the same time, ArchCo can use the 4% of gross receipts method for the design of the shopping mall, which results in an additional commission of \$200,000 [4% of \$5,000,000] to the IC-DISC. The total amount of the IC-DISC's income is \$700,000.

A technique for increasing the taxable income from foreign projects is to reduce the expenses allocated to foreign revenues. Taxable income equals the excess of gross receipts over the total costs of the firm, which includes expenses that are definitely related to foreign projects and a ratable portion of any expenses that are not definitely related to any specific class of gross income (e.g., interest expense and selling, general, and administrative expenses).¹⁶ Therefore, a taxpayer can increase taxable income and, in turn, the amount of its IC-DISC's commission, by developing defensible apportionment bases that allocate fewer expenses against foreign revenues.¹⁷

Example 6. EngCo, a U.S. engineering firm, earns \$36 million of revenue in both the United States and foreign markets. For its foreign projects, EngCo has \$12 million of revenue based on 5,000 hours of work. For its domestic sales, EngCo has \$24 million of revenue based on 15,000 hours of work. EngCo incurs \$10 million of indirect expenses that it must allocate between foreign projects and domestic projects. If EngCo allocates the indirect expenses based on revenue, \$3.3 million (\$10 million of indirect expenses times [\$12 million of foreign revenue divided by \$36 million of total revenue]) would be allocated to foreign projects. However, if EngCo allocated the indirect expenses based on hours worked, only \$2.5 million (\$10 million of

indirect expenses times [5,000 hours worked on foreign projects divided by the 20,000 total hours worked]) would be allocated to foreign projects. By allocating fewer indirect expenses to foreign projects *via* an allocation based on hours worked (\$2.5 million instead of \$3.3 million), the taxable income and, accordingly, the commission should be greater.

The owners of a passthrough entity, such as an S corporation or an LLC, may have the IC-DISC as either a subsidiary or as a brother-sister entity of the firm. Just as with the brother-sister structures previously depicted, the parent-subsidiary structure also provides 20% tax savings as the dividend from the IC-DISC is a separately-stated item of income of the flow-through entity (see Figures 6 and 7).

The owners of a C corporation may only have the IC-DISC as a brother-sister entity because there is not a dividends received deduction for dividends received from an IC-DISC.¹⁸ However, as aforementioned, the tax benefits are great because the commission removes the income from corporate tax (see Figure 8).

The firm could achieve even greater tax savings by forming an IC-DISC that *only* performs architectural or engineering services for projects located abroad. In such a scenario, the IC-DISC would employ the service providers, the engineers or architects. Accordingly, the IC-DISC would receive all the income from the foreign project and, when the IC-DISC distributes all the income as a dividend, all the income is a qualified dividend that is taxed to the owner at only 20%. Even if the firm has both domestic and foreign projects, the owners could form such an IC-DISC exclusively for the foreign projects.

Example 7. Engie the engineer owns EngCo, an S corporation. EngCo earns \$600,000 of revenue, all of which is from consulting on construction projects located in Europe. By filing a Form 4876-A for EngCo, Engie converts EngCo to an IC-DISC, which does not pay any tax. When EngCo distributes a dividend to Engie, the dividend is a qualified dividend on which Engie only incurs income tax at a 20% rate on all the income (see Figure 9).

Execution is critical to ensure that the IC-DISC and the services for the projects abroad qualify for this benefit. Implementation considerations include the following:

FIGURE 7.

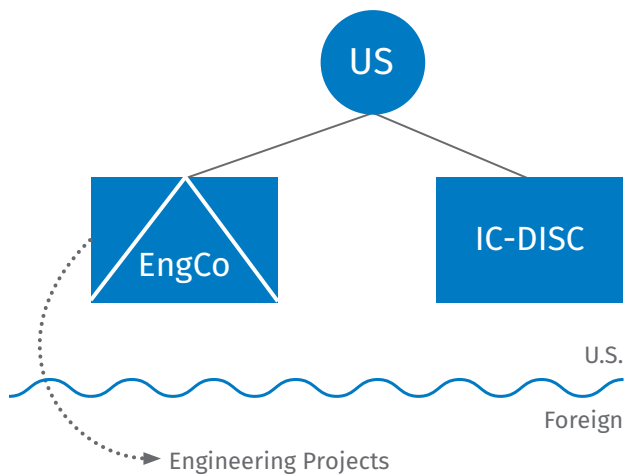
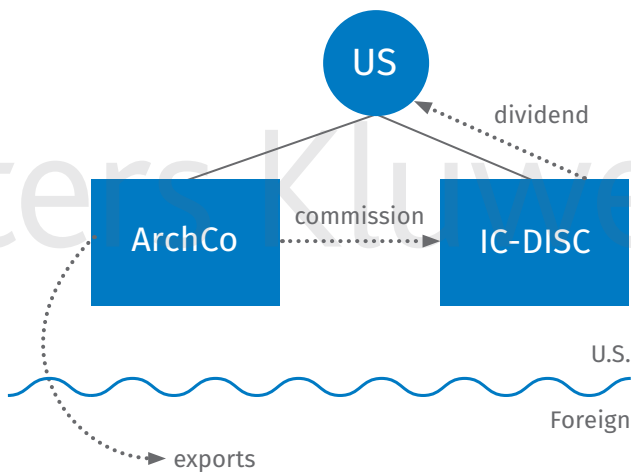
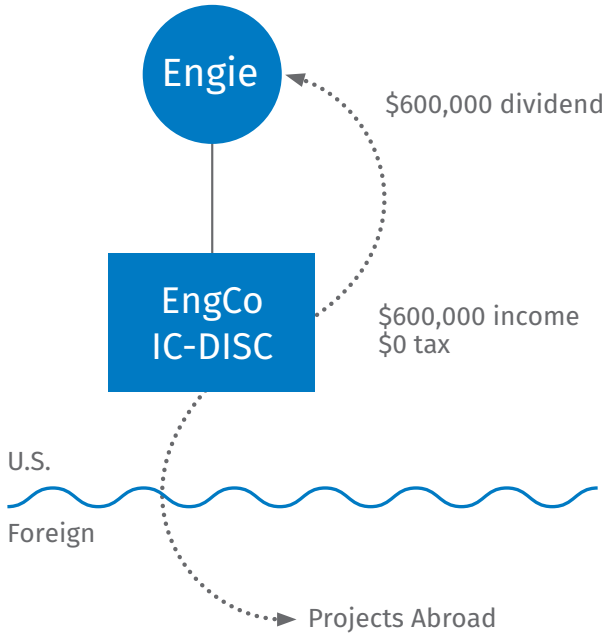


FIGURE 8.



- Incorporate the IC-DISC before the revenue is booked;
- Analyze the projects to ensure that the firm captures all architectural or engineering services performed anywhere for foreign projects—including those in neighboring North American countries;
- Draft the commission agreement between the IC-DISC and the architectural or engineering firm;
- Prepare and file the Form 4876-A that elects IC-DISC status for the architectural or engineering firm; and
- Prepare a manual that contains guidelines for the firm's operating procedures, which should include a checklist and a calendar to determine when the firm should complete various activities.

FIGURE 9.



ENDNOTES

- * The author previously worked for the IRS Chief Counsel (International) in Washington and managed the international tax practice for a region of a Big Four accounting firm. He can be reached at rmisey@reinhardt.com.
- ¹ Code Sec. 1(h)(11).
- ² At this time, the IRS has not issued definitive guidance as to whether the 3.8% net investment income tax applies to a dividend received from an IC-DISC. Even if the net investment income tax applies, the tax savings are still significant.
- ³ Code Sec. 1. The top individual tax rate is 39.6%.
- ⁴ After a corporate tax rate of 35%, the qualified dividend rate of 20% results in an effective rate of 48%, which is 28 percentage points higher than the 20% dividend rate.
- ⁵ Code Sec. 995(f)(2). A U.S. shareholder must continue to pay interest on deferred IC-DISC income until that income is distributed or deemed distributed by the IC-DISC. The interest rate is the current market rate for 52-week Treasury bills. Code Sec. 995(f)(4).
- ⁶ Code Sec. 992(b).
- ⁷ Code Sec. 992(a)(1)(c).
- ⁸ Code Secs. 992(a)(1) and 993(d) and (f).
- ⁹ Code Secs. 992(a)(1)(E) and 993(b).
- ¹⁰ Code Sec. 992(a)(1)(A) and (B).
- ¹¹ Code Sec. 993(a)(1)(G); Reg. §1.993-1(h).
- ¹² Reg. §1.993-1(h)(6).
- ¹³ Reg. §1.993-1(h)(5).
- ¹⁴ Code Sec. 994(a).
- ¹⁵ Reg. §1.994-1(d)(3)(ii).
- ¹⁶ Reg. §1.994-1(c)(6)(iii).
- ¹⁷ For an example in the context of research and development expenditures, see *St. Jude Medical, Inc.*, CA-8, 94-2 USTC ¶150,459, 34 F3d 1394.
- ¹⁸ Code Sec. 246(d).

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