

WEALTH PRESERVATION AND TAX PLANNING ALERT

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Interest Charge-Domestic International Sales Corporations (“IC-DISC”) – The Exporter’s Federal Tax Break

International trade has been and remains big business in Florida. The U.S. Census Bureau has estimated that Florida firms exported over \$55 billion of products in 2010, and that Florida is the fourth largest exporting State in the U.S.

Many of these exporters may benefit from a relatively unknown Federal income tax incentive known as the “IC-DISC” – the “Interest Charge-Domestic International Sales Corporation.” We discuss below the main income tax benefits of the IC-DISC for qualifying exporters.

Origin of the IC-DISC

Very briefly summarized, the IC-DISC is one of several major export incentives instituted by Congress under the Internal Revenue Code over multiple decades. In 1971, Congress created the predecessor to the IC-DISC in a form called the “DISC” regime (“Domestic International Sales Corporation”), which generally allowed deferral of tax on all net income from qualified exports until distributed.

In 1984, due to foreign challenges under GATT, Congress replaced the DISC with the “FSC” (the “Foreign Sales Corporation”), but also created the current IC-DISC regime for relatively smaller taxpayers.

In 2000, Congress replaced the FSC with the “ETI” exclusion (“Extra-Territorial Income”) due to foreign challenges through the World Trade Organization, and, for the same reason, repealed the ETI exclusion in 2003.

Perhaps surprisingly, throughout this tumultuous history of U.S. export incentives, there was relatively little if any foreign challenge to the IC-DISC regime. Today, the IC-DISC is the sole U.S. income tax program designed specifically to benefit qualifying U.S. exporters.

Basic Requirements / Qualifying Exporters

To use an IC-DISC, exporters must sell or lease qualified export property for use, consumption, or disposition outside of the United States. Qualified export property includes property:

1. Which is deemed to be manufactured, produced, grown, or extracted in the U.S. by a person other than an IC-DISC; and

2. Not more than 50% of the value of which is attributable to foreign content.

Exporters may make delivery of qualified export property within the U.S. via an agent (such as a freight forwarder or warehousing agent) as long as the product is ultimately delivered outside the United States within 1 year from the time of sale. The qualified export property also must not be subject to any further manufacturing or other processing by any person between the time of sale and the ultimate delivery outside the United States.

Certain architectural and engineering services considered as export services also qualify for IC-DISC benefits. Architects and engineers who perform services in the U.S. or abroad are considered to render export services if the services are related to foreign construction projects.

Additionally, the following requirements apply on an annual basis in order for a corporation to preserve status as an IC-DISC:

1. At least 95% of the IC-DISC’s annual receipts must be qualified export receipts (revenues from the sale or lease of qualified export property); and
2. At least 95% of the assets held by the IC-DISC as of the end of each year must consist of qualified export assets (assets held in connection with exporting activities such as working capital, trade receivables, and facilities used to sell or service export product).

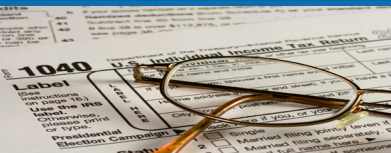
Structure and Tax Benefits of an IC-DISC

An IC-DISC is a corporation formed under State or District of Columbia law which makes an election to be classified as an IC-DISC for Federal income tax purposes. An IC-DISC may have only a single class of stock; it requires only \$2,500 of capital.

Unlike a “C corporation,” an IC-DISC is not subject to Federal income tax at the corporate level. An IC-DISC is a flow-through entity which pays dividends to its shareholders.

In a common structure, an IC-DISC earns a commission from an affiliated exporter. The exporter pays a commission to the

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IC-DISC equal to the greater of 4% of the exporter's qualified export receipts, or 50% of the exporter's taxable income. The exporter deducts the commission payment in full, and the IC-DISC either distributes retained earnings or makes same available for reinvestment back into the export business.

Another scenario, often overlooked, involves indirect export of U.S. product. In other words, a company may qualify for IC-DISC benefits if it sells qualified export property to another U.S. company which ultimately exports such product for use outside the U.S.

Properly structured and implemented, the IC-DISC provides the following primary benefits under current law:

1. Favorable income tax rates: Dividend distributions from the IC-DISC are subject to Federal income tax at the qualified dividends rate of 15%, and thus are not subject to ordinary income tax rates (35% currently is the highest marginal individual income tax rate);
2. Deferral of Income Tax and Increase in Cash Flow: IC-DISC shareholders annually can defer the payment of tax on up to \$10 million of net income attributable to qualifying export revenue as long as the corporation reinvests such income in the exporter business; and
3. Reduction in Employment and Self-Employment Taxes: Dividend distributions from the IC-DISC are not subject to Federal Social Security (FICA), Medicare, or self-employment taxes.

With respect to income tax rates, Congress has extended the preferred rate of 15% applicable to qualified dividends through 2012. It remains to be seen whether it will extend this rate preference in 2013 and thereafter.

Bills have circulated in Congress from time to time regarding repeal of the IC-DISC regime. To this point, none have seemed to generate material support, especially given the economic climate and ongoing U.S. trade imbalance. As one barometer, the Obama Administration has previously pledged to double exports by 2015.

With respect to the deferral of income tax, if an IC-DISC opts for deferral, its shareholders will incur an interest charge on the deferred tax liability. This charge equals the average yield on Treasury bills with a constant maturity of 1 year; as of the end of September 2011, this rate was 0.22%.

Thus, to the extent that an exporter's cost of capital exceeds the applicable Treasury bill rate, an IC-DISC which defers the distribution of earnings may reduce its borrowing costs (subject to the annual limitation of \$10 million of qualifying net income). Deferral continues until the actual distribution of the qualifying income.

With respect to employment and self-employment taxes, it is possible that future legislation will subject dividends to these taxes.

Separate and apart from commission income, an IC-DISC may be able to purchase accounts receivable from the affiliated exporter at a discount / on a factoring basis, and to conduct promotional activities for the affiliated exporter on a cost-plus basis. Where applicable, these additional items of income would not count against the annual limitation of \$10 million of qualifying net income, and would be eligible for either current distribution or deferral.

In the Exhibit on the following page, we have provided an example of the income tax savings which a qualifying exporter may obtain under current law from an IC-DISC.

Summary

The IC-DISC can serve as a powerful tool for qualifying exporters to reduce and defer the payment of their Federal income tax obligations on qualifying export income. The uncertainty over future income tax rates, particularly the rates applicable to dividends, makes it impossible to quantify the total package of benefits from an IC-DISC for 2013 and subsequent tax years. However, while the IC-DISC regime remains in effect, the opportunity to defer income in and of itself may provide a sufficient benefit to implement the strategy in appropriate situations.

Additionally, in the closely-held setting, there are alternative legal structures for the ownership of the capital stock of an IC-DISC which may provide material estate planning benefits.

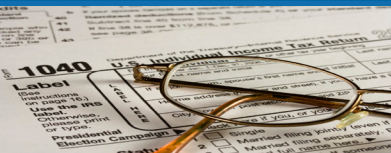
This summary is not exhaustive, and numerous requirements condition the application of the IC-DISC rules. As always, it is necessary for taxpayers to consult with their tax representatives in order to determine the potential eligibility for and benefits from an IC-DISC in their particular fact pattern. Where applicable, though, the IC-DISC may add material value and enable a taxpayer to accomplish multiple objectives. ■

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EXHIBIT - CALCULATION OF FEDERAL TAX BENEFITS FROM USE OF AN IC-DISC

	<u>WITHOUT IC-DISC</u>	<u>WITH IC-DISC</u>
<u>Export Company</u>		
Qualified Export Gross Receipts	25,000,000	25,000,000
Cost of Goods Sold	<u>(20,000,000)</u>	<u>(20,000,000)</u>
Gross Margin	5,000,000	5,000,000
General and Administrative Expenses	<u>(3,500,000)</u>	<u>(3,500,000)</u>
Export Net Income	1,500,000	1,500,000
IC-DISC Commission Deduction (greater of):		
1) 50% of Export Net Income	-	(750,000)
2) 4% of Export Gross Receipts	-	(1,000,000)
IC-DISC Commission Deduction	-	(1,000,000)
Federal Taxable Income (after deducting IC-DISC Commission)	1,500,000	500,000
Federal Income Tax @ 35% rate	525,000	175,000
IC-DISC Shareholder Dividend Income	-	1,000,000
Federal Income Tax @15% rate	-	150,000
Total Federal Income Tax	525,000	325,000
Total Proceeds to Shareholders	975,000	1,175,000
Combined Permanent Federal Tax Savings		200,000

Note: Exhibit assumes the exporter is a flow-through entity ("S" corporation or partnership).

Different rates, and state corporate income taxes, generally apply in the C corporation setting.

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