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Guest Column

Privately owned U.S. exporters may get tax benefits with an IC DISC

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Since the recent repeal of the Extraterritorial Income Exclusion, tax savvy U.S. exporters are looking for ways to replace the tax benefits they will start losing in 2005 on their export profits.

The American Jobs Creation Tax Act of 2004 is phasing the tax benefits of the EIE out over 2005 and 2006, as a response to the World Trade Organization deeming the EIE as a harmful tax policy. Many privately owned businesses and their advisers are unaware that significant export tax benefits are available through a tax policy that has been in effect since 1984.

Congress enacted the Interest Charge Domestic International Sales Corporation [IC DISC] in 1984 to create incentives for U.S. exporters.

As originally enacted, the IC DISC generally provided a tax deferral for profits on the first $10 million of export sales. Before 2003, competing export tax policies were generally more beneficial than the IC DISC, and the IC DISC received very little attention.

However, in 2003 Congress reduced the dividend tax rate on individuals to 15 percent. Consequently, the IC DISC became a very effective tax strategy for exporters. Moreover, the IC DISC is the only export tax incentive available for taxpayers after 2006.

In most cases the IC DISC brings more tax benefits in 2005 and 2006 than the EIE. The IC DISC benefits are available to Limited Liability Companies, partnerships, S-Corporations and closely held C Corporations.

Here is how it works

The owners of an exporting company will form a new corporation and elect to treat this entity as an IC DISC for federal tax purposes. The IC DISC will usually have the same ownership structure as the exporting company.

The exporting company will enter into a commission agreement with the IC DISC. The IC DISC is permitted to charge the exporting company a commission on the exporting company's qualified export sales. The commission is calculated under various methods provided by IRS regulations, but the two most common approaches are:

- 4 percent of the revenue of the qualified export sales; or
- 50 percent of the taxable income of the qualified export sales.

The commission expense is fully deductible by the exporting company. The IC DISC is tax exempt on its commission income.

Income tax is only imposed on dividends to the IC DISC shareholders. However, the dividends are taxable at 15 percent.

Consequently, taxpayers that were normally paying 35 percent income taxes on their export profits may be able to reduce their income tax rate to 15 percent on half of those export profits. This leads to significant annual tax savings for many exporters.

The existence of the IC DISC will be transparent to the export company's customers. The IC DISC will not impact the operations of the export company. The IC DISC is not required to have employees or perform any specific

function.

Distributors or manufacturers may qualify for the benefit on their export sales. Moreover, distributors and manufacturers may claim an IC DISC benefit on the same export product.

However, the distributor will be required to share copies of its bills of lading with the manufacturer. In addition, the distributor generally must not further process or change the manufacturer's product before it is exported.

For a corporation to qualify as an IC DISC, it must be a U.S. corporation with one class of stock that has a par value of at least $2,500. Also, at least 95 percent of its income must be from exports and 95 percent of its assets must be export related. No more than 50 percent of the fair market value of its exported products can be attributable to articles imported into the United States.

While the rules for defining what qualifies as export income and export assets are quite technical, the reality is that meeting the 95 percent thresholds is not particularly difficult. The IC DISC was originally created as an export incentive. Thus, the regulations were intentionally drafted to be favorable to exporting

taxpayers.

What may be surprising to many architects and engineers is that their services can also qualify for IC DISC benefits. Only services for construction projects located outside of the United States qualify. However, the professional services related to those projects can be performed in the United States.

IC DISCs can significantly reduce the tax rate on export profits. However, the benefits cannot start until the IC DISC has been formed. Because states tax IC DISCs differently, companies should discuss with their tax adviser the preferred state of incorporation.

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