Interest-Charge Domestic International Sales Corporations (IC-DISC): The Last Remaining U.S. Export Incentive

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U.S. exporters may be able to reduce their U.S. effective tax rate by establishing an IC-DISC. An IC-DISC is a C-corporation that is exempt from all forms of federal taxation (although some states tax IC-DISCs as C-corporations). Usually, an IC-DISC is a "paper" entity that is established by a U.S. exporter as a controlled subsidiary or brother/sister corporation. To qualify for favorable tax treatment, an IC-DISC must export qualifying property (e.g., property with sufficient U.S. content) and must meet certain other requirements.

Under the IC-DISC regime, the U.S. exporter pays commissions to the IC-DISC. The commissions represent the IC-DISC's sole source of income and generally equal the greater of: (i) 4% of qualified export receipts, or (ii) 50% of the taxable income associated with the qualified exports.

TEMPORARY AND PERMANENT TAX BENEFITS OF AN IC-DISC

The implementation of an IC-DISC can result in both temporary and permanent tax benefits. An IC-DISC can provide temporary tax benefits to a U.S. exporter by permitting the U.S. exporter to defer the taxation of up to ten million dollars of qualified export receipts until those receipts are distributed to the IC-DISC's shareholders. The IC-DISC shareholders are required to pay only a nominal “interest charge” to the IRS with respect to taxes that are deferred on the IC-DISC's income.

A U.S. exporter that is a closely-held C-corporation can use an IC-DISC to obtain a permanent tax benefit in the form of a tax deduction for the U.S exporter's commission payments to the IC-DISC. Those commissions can then be distributed by the IC-DISC to its shareholders as a dividend. As such, an IC-DISC can be an effective tool for getting cash to the shareholders of a closely-held C-corporation free from the corporate "double tax." This strategy can augment or potentially replace non-deductible C-corporation distributions.

For a U.S. exporter that is a flow-through entity such as an S-corporation or an LLC, the permanent tax benefit is obtained by using the IC-DISC to convert a portion of the U.S. exporter's “ordinary income” into “qualified dividend income.” This can result in a 20% tax savings on qualified export receipts, which is the difference between the 35% top marginal tax rate for "ordinary income" and the 15% rate for "qualified dividend income."

IMPLEMENTATION: WEIGHING THE COSTS AND BENEFITS

Any U.S. company with export sales should be aware of the IC-DISC structure. Although the realization of an IC-DISC strategy does entail implementation and administrative expenses (e.g., formation of the requisite entities, drafting of the IC-DISC commission agreement, and tax planning advice), the tax benefits may be far greater and warrant consideration.