Is Implementing an IC-DISC the Right Strategy for Your Export Business?

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Under U.S. tax law, the Internal Revenue Service provides a tax incentive to U.S. companies exporting goods that are manufactured in the United States. This incentive is utilized by setting up and implementing an Interest Charge Domestic International Sales Corporation ("IC-DISC"). If your organization earns income from exporting U.S.-made products, you may wish to consider forming an IC-DISC to reduce your effective federal tax rate on export income.

What is an IC-DISC, How to Set it Up, and Operating Requirements

An IC-DISC is formed as a domestic C Corporation that has made a valid election to be treated as an IC-DISC for federal tax purposes. The DISC regime was introduced to stimulate exports of U.S. manufactured goods and encourage manufacturing operations in the United States.

An IC-DISC may be used as nothing more than a legal paper entity and need not have any corporate substance. There is no requirement to maintain an office, have employees or own any tangible assets. The only requirements are that the entity:

- Is organized as a U.S. corporation
- Elects to be treated as an IC-DISC
- Maintains of a separate bank account

- Keeps annual accounting records
- Files annual income tax returns
- Has $2,500 in capital stock each day during its taxable year
- Has a single class of stock
- Has at least 95% of its gross receipts from qualified gross receipts
- Has at least 95% of the tax basis of its assets from qualified export assets

How Does it Work?

The IC-DISC may be formed as a brother-sister corporation or as a subsidiary of the U.S. exporting corporation ("Exporter"). Exporter sells goods made in the U.S. to foreign purchasers. Exporter then pays a commission to the IC-DISC equal to the greater of the following:

- 4% of qualified export receipts from the sale of the goods
- 50% of the combined taxable income attributable to qualified export receipts from the sale of the goods

The IC-DISC is not required to pay federal income tax on the commission income. Thus, income tax is deferred until the commission income is distributed to the ultimate shareholders in the form of a dividend. Individual shareholders may apply the 20% or 23.8% (as the case may be) federal tax rate on qualified dividends resulting in a permanent federal tax savings of up to 19.6% (39.6% - 20%) on the commission income

Tax Advantages of the IC-DISC

The tax benefits are realized as follows:

1. The receipt of this commission income is tax-free to the IC-DISC for federal tax purposes

2. The Exporter may deduct this amount as an expense, thereby reducing its taxable income that may be subject to the 39.6% the marginal tax rate.

3. The IC-DISC may choose to do one of the following:

a. Keep this commission income (up to a statutory maximum) and defer any tax payments on these amounts. The shareholders of the IC-DISC then must pay a very small interest charge on this deferred amount. The interest rate is tied to the Treasury bill rates which have been a fraction of 1% in recent years.

b. Pay a dividend to its shareholders up to the amount of its accumulated net commission income. Individual shareholders pay a qualified dividend tax rate on the dividends at rates of either 20% or 23.8%.

c. Lend accumulated IC-DISC earnings back to the Exporter in exchange for a note and charge interest at an arm's length rate. The Exporter may deduct the interest expense and the IC-DISC shareholders pay tax on a deemed dividend in the amount of its interest income. This increases the amount of the IC-DISC benefit and retains the cash with the Exporter.

State Tax Considerations

Planning may be necessary and careful consideration needs to be given to minimize state tax consequences of an IC-DISC.

The California Franchise Tax Board ("FTB") recently issued guidance that would essentially make the IC DISC tax neutral for California tax purposes. On June 4, 2015, the FTB concluded in Legal Ruling 2015-02 that in situations where 2 or more persons own or control both the entity paying the commission and the IC DISC, the FTB has the authority to and will allocate the books and records of the IC DISC to the entity that makes the sales attributed to the IC DISC. In other words, where an exporter and an IC DISC are controlled by the same persons, the IC DISC's income and expenses should be allocated to the exporter and reported on the exporter's California tax return. This assumes that the DISC is a shell entity with no activity or operations. Therefore, pursuant to this ruling no income or expense would be reported on the IC DISC's California tax return and the IC DISC would only be liable for the annual $800 minimum franchise tax.