

White Paper

Re-examination of the IC-DISC

The Interest Charge International Sales Corporation (IC-DISC) has been a boon to United States exporters for years. Recent changes to the tax code have, once again, made the IC-DISC a top priority for businesses that export.



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Overview

Congress has a long history of promoting United States exports via the Internal Revenue Code (IRC). Recent changes to the IRC have further solidified the long-term financial rewards available to United States exporters. The changes should make a review of the opportunity a top priority for U.S. firms that export. Furthermore, computational techniques allowed by statute and regulations encourage United States taxpayers to maximize their share of tax benefits. However, capturing the opportunity requires swift action to ensure taxpayers capitalize on all of the available benefits. Taxpayers need to act now to capitalize on these generous benefits whether the firm is a market maker or rank-and-file provider in the industry.

"The White House and Congress agree that a key to our nation's economic recovery is strengthening our manufacturing sector and encouraging exports. The IC-DISC is tailor-made to encourage exactly such activity – providing a tremendous tax incentive for small and medium business owners who manufacture and export." (Zerbe, Forbes, 3/29/2011)

| IC DISC Features | Benefits |
|---------------------------------------|--|
| Permanent Tax Savings on Export Sales | Up to 16% Federal Tax Savings on Export Profit |
| Increased Business Value | Additional Cash Flow Strengthen Balance Sheet |
| Leverage Cost of Capital | Reinvest at Lower Cost of Capital |

Interest Charge Domestic International Sales Corporation (IC-DISC)

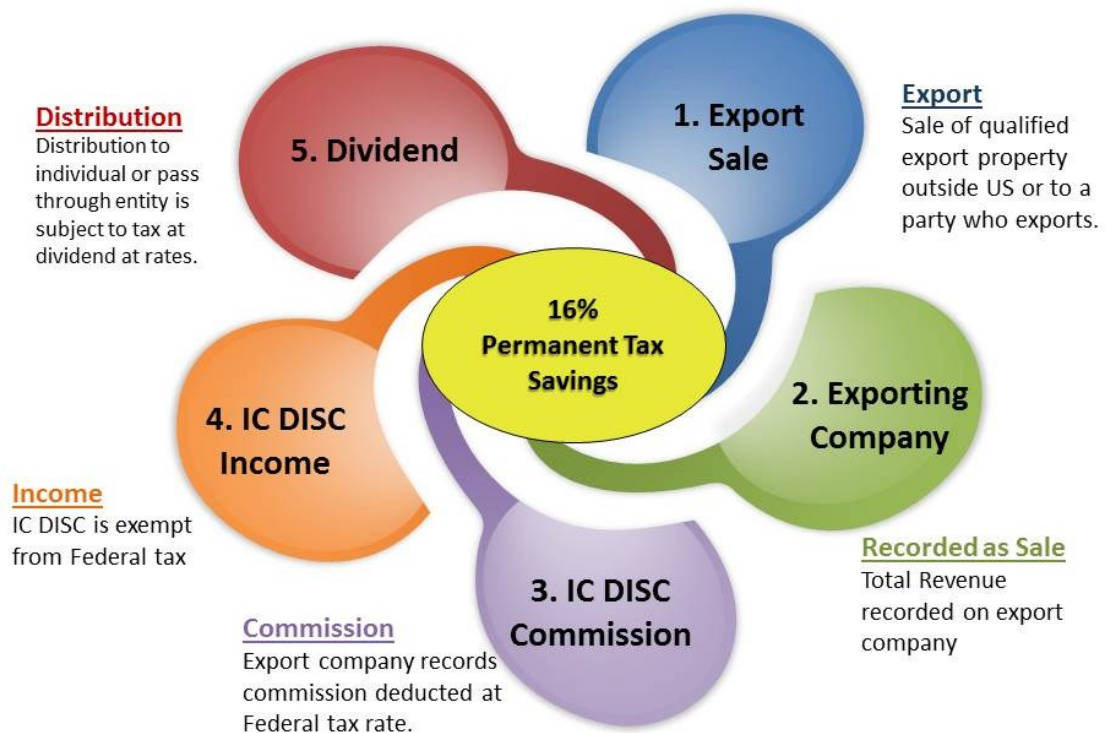
The IC-DISC is a workhorse when it comes to federal income tax benefits. The DISC arrangement was originally created by Congress in 1972 as a means to promote United States exports. The original concept remains to this day, provide tax incentives to exporting enterprises.

For many years, the IC-DISC provided a rather lacklustre tax deferral benefit for exporters. The Job and Growth Tax Relief Reconciliation Act of 2003 breathed new life into the IC-DISC. By reforming the Federal dividend tax rate, Congress opened the door to a permanent tax savings of 20% to exporters.

The changes created a flood of new IC-DISC's, for taxpayers eager to claim their share of export incentives. The IC-DISC continued for almost years until many of the reforms included in the 2003 act were set to sunset at the end of 2012 and potentially push dividend tax rates back up to match ordinary income rates. Planners were aware of the potential change in the years approaching 2012 and advised their clients to approach the IC-DISC with caution in the event the dividend rate was allowed to return to ordinary income rates.

The American Taxpayer Relief Act of 2012 (ATRA) passed in December 2012 provides the long-term assurance sought by taxpayers. The passing of ATRA restored the IC-DISC into the arsenal of tax planning. The ATRA made permanent the dividend tax rate to individuals with a maximum of 20%. In addition, the ATRA also added the Unearned Medicare Contribution Tax of 3.8% computed on net investment income, creating a maximum dividend rate of 23.8%

How an IC-DISC Works



- The IC-DISC is a “paper” entity sanctioned by the IRC to act as a conduit for export tax savings. Taxpayers are not required to have employees, office space, or any other substance. Rather, by complying with statute and regulatory requirements, an entity incorporated in the United States with the correct elections becomes the tax saving vehicle.
- The owner-managed business or shareholders of the business incorporate a new entity and make all elections to be a tax-exempt IC-DISC
- The exporting company pays a commission to the IC-DISC based on export profit.
- Exporting company deducts the commission at its marginal tax rate. For many business owners, the rate will be 39.6%.
- IC-DISC pays no tax on the commission
- Shareholders pay income tax on dividends as modified by ATRA of 23.6%.
- The result is a 16% permanent tax savings on the amount of the commission.

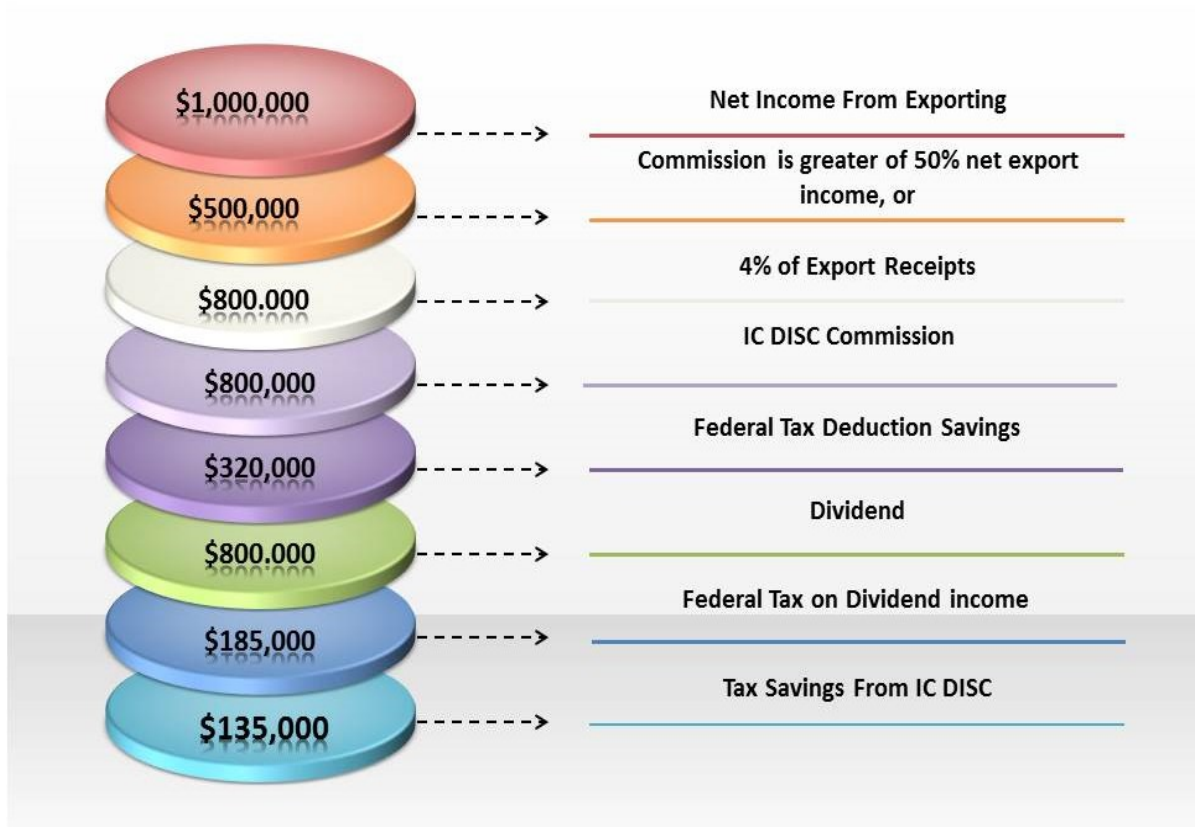
What an IC-DISC Can Do for a Business

The IC-DISC can be used in a variety of methods to help achieve business, financial, and operational goals and objectives.

Permanent tax savings begins with the exporting company deducting the commission paid to the IC-DISC. The commission deduction is made against ordinary income and has the effect of a tax savings at the amount of the commission multiplied by the marginal tax rate, the top rate is 39.6% for flow-through entities such as S corporations and Limited liability companies. The top marginal rate for a C corporation is 35%.

The statute sets the commission rate as the greatest of either 50% of net income or 4% of export revenue.

Because the IC-DISC is tax exempt, shareholders upon dividend receipt pay tax. Individual and pass-through company shareholders pay income tax on dividends at the top rate of 23.6%. The following example illustrates how a 16% rate arbitrage creates a permanent tax benefit.



- ⇒ Increases liquidity for shareholders or the business
- ⇒ Shareholders who need to rebalance their investment risk profiles can, in most cases, use the IC-DISC to gain additional liquidity. By extracting cash in this tax-advantaged manner, they can deploy resources pursuant to their investment risk profiles.
- ⇒ IC-DISC liquidity also provides a tool for combating lending and debt restrictions that inhibit diversification and risk management. Rather than being reined in by restrictions, such as salary and dividend limitations and debt covenants, shareholders have flexibility to take actions that serve the best interests of the business
- ⇒ An IC-DISC is more than a tax-saving vehicle. It can also be used as a deferral tool to leverage a company's cost of capital. IC-DISC earnings need to be distributed to shareholders; they can instead be used to perpetuate and grow the deductible dividend tax-rate savings.
- ⇒ Lending accumulated IC-DISC earnings back to the exporting company in return for a note and interest perpetuates tax-rate savings. The exporting company can deduct the interest expense and interest income is considered a dividend to the IC-DISC shareholders. Reinvesting IC-DISC earnings back into the exporting business results in additional tax-rate savings and diminishes the Group's cost of capital.

Technical Specifications

Care needs to be taken when establishing the IC-DISC to ensure the statutes and regulations are followed and proper procedures are followed to make all of the appropriate legal and tax elections necessary to become qualified as an IC-DISC in the eyes of the Internal Revenue Service.

Further, statute and regulations provide that record keeping and documentation are necessary to ensure deductibility. Experienced practitioners are able to assist in the establishment of proper procedures to ensure compliance with Internal Revenue Service requirements.

Documentation of transactions and expenses are critical to optimizing the IC-DISC benefits. Statute and regulations provide a number of computation methods that enhance the available deduction. Experienced practitioners are able to assist taxpayers in navigating the rules and capturing the largest benefit available for the enterprise or investor.

Summary

IC-DISC incentives provide United States exporters a great financial advantage to contribute toward the start-up or on-going maintenance of an international business. The 16% permanent tax savings on profits from exports allow businesses the seed capital and financial flexibility to participate in markets worldwide.

The regulations and the processes can be confusing, but we can guide you through the process. L. Harris Partners has a wealth of experience in identifying and implementing export incentive opportunities on behalf of clients. We've been helping businesses of all sizes and in many industries maximize export incentives for almost 20 years. Our proprietary tools can simplify the maze of statute and regulations.

If you'd like a no-cost assessment of your situation to find the most advantageous and least intrusive process while maximizing benefits, contact us today.

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NOTES & QUESTIONS: