The ABCs of an IC-DISC

Covering the concepts behind an IC-DISC structure, and the benefits of establishing it

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Manufacturing & Distribution Lite Paper

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This lite paper addresses the U.S. tax advantages and consequences of using an Interest Charge Domestic International Sales Corporation (IC-DISC) with respect to export sales. It is designed to be a general overview of IC-DISC structures, so we recommend you conduct further analysis based on the specific facts and circumstances of your company.

Why would a company establish an IC-DISC?

Establishing an Interest Charge Domestic International Sales Corporation, or IC-DISC, is an opportunity that's offered as an exporting incentive for U.S. firms. An IC-DISC is an entity that your company simultaneously creates and enters into a written agreement with. This corporation is not subject to corporate income tax. Instead, the tax is deferred until the income is paid as a dividend to its shareholders. The IC-DISC may be used by your company and its affiliates to facilitate the sale of equipment that is manufactured in the U.S. and sold outside the U.S. Property is considered to be "sold outside the U.S." as long as the ultimate destination of the property is a foreign location. The ultimate destination test is met if property is sold to a customer in the U.S. but the property is shipped to a foreign destination by that customer within one year. In addition, engineering services performed in the U.S. can qualify for treatment as an export sale for this purpose if the benefits of such services are realized outside the U.S.

IC-DISC Treatment

A corporation that qualifies as an IC-DISC is not subject to the corporate income tax pursuant to IRC § 991 and Treas. Reg. § 1.991-1. Instead, the tax is deferred until the income is paid as a dividend, or is deemed to be paid as a dividend under IRC § 995, to the shareholder. Under Treas. Reg. § 1.995-1(c), the income is treated as a dividend to the shareholder. Such a dividend to the individual shareholder qualifies as a "qualified dividend" entitled to the reduced tax rate of 20%.

IRC § 992(a) defines an IC-DISC as a corporation which has satisfied the following conditions:

1) 95% or more of its gross receipts consist of "qualified export receipts";

2) the adjusted basis of its "qualified export assets" is at least 95% of the adjusted basis of all of its assets;

3) it has only one class of stock and the par value of its outstanding shares is at least $2,500; and

4) it has made an election to be treated as an IC-DISC.

"Qualified export receipts" include "gross receipts from the sale, exchange, or other disposition of export property" (IRC § 993(a)(1)). Engineering and architectural services performed in the U.S. or in a foreign jurisdiction also qualify if the ultimate benefit of such services is enjoyed outside the U.S.

"Export property" is defined as property that:

1) is manufactured in the U.S. by a person other than a DISC;

2) has less than 50% of its fair market value attributable to imported articles; and

3) is held for sale by or to an IC-DISC for use outside the U.S. (IRC § 993(c)).

In the event that the income to be received by the IC-DISC is commission income, "gross receipts" for purposes of the 95% test are the gross receipts on the sale of the property on which such commissions arose (IRC § 993(f)).

In commission transactions involving a DISC and a related supplier, Treas. Reg. § 1.994-1(a) provides the intercompany pricing computation for determining the amount of income to be reflected by the IC-DISC. The commission income is limited to the greater of 50% of the net income related to the export sales or 4% of the gross receipts, not to exceed the net income.

The parameters of an IC-DISC

To meet the technical definition of an IC-DISC, the new corporation should have no more than one class of stock with a total par value of at least $2,500. Professionals typically recommend $3,000 to cover any fees to be paid by the corporation. The election to be treated as an IC-DISC should be made on Form 4876A and must be filed within 90 days after the beginning of the tax year. The election is valid until it is revoked or terminated. However, the termination of the election will result in a deemed distribution of any accumulated income of the IC-DISC. Companies must determine the proper ownership structure in order to ensure full advantage of the reduced tax rate on the dividends.

The commissions received by the IC-DISC are deferred from U.S. taxation until a dividend is paid to the shareholder. An exception to this rule exists for commission income computed on foreign gross receipts in excess of $10,000,000. In this instance, the income is treated as a deemed distribution in the current year and is taxable to the shareholders in the current year whether or not paid to the shareholders in that year. As previously stated, the amount of commission income which is entitled to deferral is determined pursuant to specific calculations provided in the tax law.

The commission income is determined using one of the following calculations:

1) 4% of qualified export receipts,

2) 50% of combined taxable income, or

3) transfer pricing arm's length amount per IRC Section 482.

Although the IC-DISC will never have to pay tax on this income, the shareholder will pay tax on the dividends paid to them. Such dividends qualify for the reduced 20% capital gains tax rate.

Structuring payments

The payment of the commissions to the IC-DISC by your company must be a payment in fact, not merely an intercompany accounting entry. To achieve this, the IC-DISC must have a separate bank account and its own set of books.

The commissions payable to the DISC will be calculated prior to the closing of your company's books at the end of the year. Your company will book Commissions Expense and Commissions Payable, while the IC-DISC will book Commissions Income and Commissions Receivable. The commission must then be paid to the IC-DISC within two months after the close of the tax year. The dividend from the IC-DISC to the shareholder should be paid prior to the end of the current tax year to avoid any interest to the IRS.

An example of potential tax savings

USCo has export sales of $6 million through its IC-DISC. Using the 4% gross receipts method, USCo will deduct a commission paid of $240,000 ($6M X 4%), resulting in a U.S. tax reduction of $84,000 (35% of $240,000). If USCo declares a dividend for this income to its sole owner, Individual A, the dividend would be taxed as a qualified dividend at a 20% tax rate for a total tax of $48,000 ($240,000 x 20%). As a result, the net tax savings would be $36,000 ($84,000 less $48,000).

Please note that dividends can also be subject to an additional 3.8% net investment income tax. This is ignored for purposes of this example but needs to be taken into account when computing the potential benefit.

Establishing an IC-DISC

To set-up an IC-DISC, a new C corporation will have to be established. The new corporation must meet the initial capitalization requirements outlined in this paper. After the corporation is established and you have documentation to that effect, you can file an election with the IRS to treat the corporation as an IC-DISC. The tax return for a calendar year IC-DISC will be due on September 15 of each year, with no extension available.

Examining if an IC-DISC is right for your company

If an IC-DISC structure sounds desirable, Clark Schaefer Hackett would be happy to explore the opportunity with you. Further analysis can be performed to ensure that your company's circumstances would be optimal for this type of structure.