

January 2010

TAX BULLETIN

IC-DISC – THE LAST EXPORT INCENTIVE

The U.S. tax law contains an important incentive for domestic manufacturers and certain service providers to defer and reduce taxes attributable to profits on export sales. These benefits can be achieved through an Interest Charge Domestic International Sales Corporation (IC-DISC). By utilizing an IC-DISC, companies with export sales of goods and services with greater than 50% domestic content can eliminate corporate level taxes on part of the profits on those sales, and can allow for deferral of the shareholder level tax on dividend distributions of such profits. For S corporations and other pass-through entities, the IC-DISC has the effect of reducing the federal tax rate on such profits by as much as 20%. Earnings from manufactured goods, sales of architectural services for projects in foreign jurisdictions, entertainment products and software all qualify for these benefits through an IC-DISC. Earnings from consulting services generally do not qualify.

To utilize the IC-DISC, the U.S. operating company ("Supplier") or its owner incorporates a domestic corporation through which the earnings from the sales of qualifying property can be paid under the terms of the Supplier's Agreement. IC-DISC status must be elected by filing Form 4876-A. The shareholders of the IC-DISC are typically the same shareholders as the Supplier, or in certain cases the Supplier itself. The earnings of the IC-DISC are paid out (or deemed paid out in certain circumstances) to non-C corporation shareholders as a qualified dividend, currently taxed at the preferential capital gains rate of 15%. The IC-DISC dividend paid to a C corporation shareholder does not qualify for the dividends received deduction. An IC-DISC must pay an interest charge on profits not currently distributed as dividends.

There are three methods for calculating the profit of the IC-DISC:

1. 4% of the gross receipts from the sale of export property;
2. 50% of the combined taxable income related to the export sales; or
3. Arm's length pricing method

The first two methods are safe harbor methods, which will yield a profit to the IC-DISC of the greater of either 4% of the total export sales or 50% of the combined export profit of the IC-DISC and related Supplier. An arm's length pricing method is generally only available to an IC-DISC that is an operating entity, and doesn't generally produce a more favorable result than the other available methods. The IC-DISC profit will then be deducted by the Supplier as a cost of sales and ultimately will be distributed to the shareholders as a qualified dividend. Due to the increased depreciation allowances and other factors, for 2009, many businesses will recognize the greatest benefit by use of the 4% calculation.

In order to qualify as an IC-DISC, the corporation must have 95% of its gross receipts from Qualified Export Receipts and must hold assets referred to as Qualified Export Assets (QEA). Ninety five percent or more of the total assets of the IC-DISC must be QEA, measured at year end. QEA includes inventory, IC-DISC trade receivables, working capital, producer's loans and certain other assets. For non-operating IC-DISCs, the amount of working capital required for operations is negligible.

The use of an IC-DISC makes good sense for companies with as little as \$500,000 in export sales. The benefit is only available for prospective sales, so the IC-DISC should be established as early as possible in the year to maximize the benefits. To discuss the use of an IC-DISC please contact Andrew Klemens at andrew.klemens@wolfco-fs.com or (630) 545-4506.