INTEREST CHARGE DOMESTIC INTERNATIONAL SALES CORPORATIONS (IC-DISC)

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IC-DISC

- Intended to encourage export of U.S. goods and select services
- World Trade Organization has found it not to be an illegal subsidy
- IC-DISC introduced in 1984
- Of benefit to medium-size closely-held businesses
- IRC Sections 991-994

IC-DISC
Benefits

- The IC-DISC itself does not pay tax on its income.
- The IC-DISC shareholder pays an interest charge on the deferred tax.
- On payment of the dividend to the IC-DISC shareholder, the shareholder pays tax on the dividend at normal dividend tax rates.

IC-DISC
Limitations

- There are two types of IC-DISCs: Commission IC-DISCs and Buy-Sell IC-DISCs

1. A **Commission IC-DISC** may receive commissions on up to $10 million of qualifying export sales per year and not pay income tax on the commission.

2. A **Buy-Sell IC-DISC** may defer income on up to $10 million of export receipts.

- Most taxpayers use a Commission IC-DISC, since it is easier to operate.

IC-DISC
Commissions

- Commission on Commission IC-DISC is the greater of:
  - 4% of qualified export receipts, or
  - 50% of the taxable income attributable to applicable export gross receipts.

IC-DISC

Tax on Distribution

- If the IC-DISC pays a dividend, a non-corporate shareholder will pay tax on the dividend at a top rate of 20%.
- The 3.8% net investment income tax may apply.
- The IC-DISC allows a taxpayer to convert income taxed at 35% to income taxed at 23.8%.

IC-DISC

Tax on Income Not Distributed

- The IC-DISC can retain its earnings and lend the money to the producer.

- The shareholders of the IC-DISC pay income tax on (1) the interest on the deferred tax and (2) the interest the IC-DISC earns on the producer loans.

IC-DISC
Example One

The IC-DISC earns $400,000 in commissions on export sales (4% commission on $10 million sales). The IC-DISC pays a $400,000 dividend to its shareholders.

The IC-DISC is owned by individual shareholders who own the related supply company. The supply company pays tax at a 35% rate.

The supply company will receive a tax deduction for the commission that saves it $140,000 in tax. The shareholders have dividend income taxed at 23.8% or $95,200 in tax. The tax benefit realized is $44,800.

IC-DISC
Example Two

The IC-DISC earns $2.5 million in commission on export sales (50% of the combined taxable income of the producer and IC-DISC on $10 million of export sales). The corporation pays tax at a 35% rate. The IC-DISC is owned by individual shareholders who own the related supply company.

The corporation will receive a tax deduction for the commission that saves it $875,000. The shareholders have dividend income taxed at 23.8% or $595,000. The tax benefit realized is $280,000.

IC-DISC
<u>Definition of Net Income</u>

A commission may equal 50% of net income attributable to the export property.

Based on the supplier's income and expenses and the IC-DISC's income and expenses.

To determine the combined taxable income attributable to the qualified export receipts, Sec. 994 applies.

Preferability of this method depends on profit margin.

IC-DISC
Definition of Net Income

- The IC-DISC can retain its earnings and lend the money to the producer The IC-DISC may choose the export sales of the supplier to report.

- The calculation of net income attributable to the export property gets complicated. Several companies provide calculations.

- Section 994 allows the taxpayer to elect marginal pricing rules where only marginal costs of producing and selling the item—*i.e.*, direct material costs and direct labor costs

- The IRS "IC DISC Audit Guide" has a lengthy discussion and examples of pricing calculations.

IC-DISC
Example Three

The IC-DISC earns $400,000 in commissions on export sales. The IC-DISC is owned by individual shareholders who own the related supply company. The company pays tax at a 35% rate.

The company will receive a deduction that saves it $140,000. The IC-DISC loans back the $400,000 to the Company.

The shareholders of the IC-DISC have dividend income equal to (1) the interest that the IC-DISC earns on the loan to the Company and (2) interest on the deferred tax.   On eventual dividend payment of the deferred income amount, the shareholder will have dividend income.

The interest rate on the deferred tax is based on the T-bill rate. The rate for 2014 is 0.11%. Rev. Rul. 2014-27.

IC-DISC
Example Four

The IC-DISC earns $2.5 million in commission on export sales (50% of the taxable income of the combined income of the producer and IC-DISC on $10 million of export sales).

The company pays tax at a 35% rate. The IC-DISC is owned by the individual shareholders who own the related supply company.

The corporation will receive a deduction for the commission that saves it $875,000 in taxes. The IC-DISC loans back $875,000 to the Company.

The shareholders of the IC-DISC will have taxable income equal to the interest on the loans to the producer and interest on the deferred tax. On eventual dividend payment of the deferred income amount, the shareholders will have dividend income.

IC-DISC
Other Restrictions

- IC-DISC must be incorporated in the U.S.
- 95% or more of the IC-DISC's receipts must be qualified export receipts
- 95% of the assets must be qualified export assets on last day of year
- Corporation must have capital of at least $2,500 and only one class of stock
- Corporation must have made an election to be treated as an IC-DISC
- Corporation must not be an ineligible entity (*i.e.*, S corporation)
- Commission charge may not put supply company in a loss situation

IC-DISC
Qualified Export Receipts

Qualified export receipts are any of the following:

- Gross receipts from selling, exchanging or otherwise disposing of export property.
- Gross receipts from leasing or renting export property that the lessee uses outside the U.S.
- Gross receipts from supporting services related to any qualified sale, exchange, lease, rental, or other disposition of export property by the IC-DISC.
- Gross receipts from selling, exchanging or otherwise disposing of qualified export assets that are not export property, but only if there is a recognized gain.
- Dividends (or amounts includible in gross income under Section 951) with respect to stock of a related foreign export corporation.
- Interest on any obligation that is a qualified export asset.
- Gross receipts for engineering or architectural services for construction projects outside the U.S.
- Gross receipts for the performance of managerial services in furtherance of the production of other qualified export receipts of an IC-DISC.

IC-DISC
Qualified Export Property

Qualified export assets are any of the following:

- Export property
- Assets used primarily in connection with the sale, lease, rental, storage, handling, transportation, packaging, assembly, or servicing of export property, or the performance of engineering or architectural services described in item 7 of *Qualified Export Receipts* above or managerial services in furtherance of the production of qualified export receipts described in items 1, 2, 3 and 7 above.
- Accounts receivable produced by transactions listed under *Qualified Export Receipts*, items 1-4, 7, or 8 above.
- Temporary investments, such as money and bank deposits, in an amount reasonable to meet the IC-DISC's needs for working capital.
- A producer's loan.
- Stock or securities of a related foreign export corporation (defined below).
- Certain obligations that are issued or insured by the U.S. Export-Import Bank or the Foreign Credit Insurance Association.
- Obligations that were issued by a domestic corporation organized to finance export property sales under an agreement with the Export-Import Bank.
- Amounts (other than reasonable working capital) on deposit in the U.S. used to acquire qualified export assets.

IC-DISC
Export Property

Export property must be:

- Made, grown, or extracted in the U.S. by a person other than an IC-DISC;
- Neither excluded under Section 993(c)(2) nor declared in short supply under Section 993(c)(3);
- Held mainly for sale, lease or rent in the ordinary course of a trade or business, by or to an IC-DISC for direct use, consumption, or disposition outside the U.S.;
- Property not more than 50% of the fair market value of which is attributable to articles imported in the U.S.; and
- Neither sold nor leased by or to another IC-DISC that, immediately before or after the transaction, either belongs to the same controlled group.

IC-DISC
Producer Loans

A producer's loan must meet all of the following terms:

- Satisfy the requirements of Sections 993(d)(2) and (3).
- Not raise the unpaid balance due the IC-DISC on all of its producer's loans above the level of accumulated IC-DISC income it had at the start of the month in which it made the loan.
- Be evidenced by a note, or other written evidence of indebtedness, with a state maturity date no more than 5 years after the date of the loan.
- Be made to a person engaged in a U.S. trade or business of making, growing, or extracting export property.
- Be designated as a producer's loan when made.

See Schedule Q (Form 1120-IC-DISC), Borrower's Certificate of Compliance With the Rules for Producer's Loans and Regulations Section 1.993-4.

IC-DISC
Documents Required

- Articles of Incorporation
- Bylaws
- Commission Agreement
- Producer Loan Notes (if applicable)

IC-DISC
Federal Tax Forms Required

- Form 4876-A, Election To Be Treated as an IC-d DISC
- Form 1120-IC-DISC (and related schedules)
- Form 8404 Interest Charge on DISC-Related Deferred Tax Liability

IC-DISC
Election Procedure

- IC-DISC must file a Form 4876-A within 90 days after the beginning of IC-DISC's year.

- All of the IC-DISC shareholders must consent to the election.

IC-DISC
Former DISC's

The shareholders of an IC-DISC that terminates its election must take the deferred tax into income over 10 years.

IC-DISC
Typical Structures

- Shareholders of a closely-held C corporation form a sister corporation that elects IC-DISC status.
- A S corporation or partnership may own the IC-DISC directly.
- A C corporation may own the IC-DISC directly, but they will only get the deferral benefit but not the rate differential benefits. See IRC § 246(d)
- The IC-DISC does not have to be owned by the same persons as the producer entity. Family members could own the stock of the IC-DISC.
- Dividends from a DISC are UBTI for a tax-exempt entity. IRC § 995(g).

IC-DISC
Audit Guide
Areas of IRS Concern

- IC-DISC properly established
- Export property properly classified
- IC-DISC commissions are properly calculated
- Return reporting errors

IC-DISC
Additional Information

- IRS IC-DISC Audit Guide
- TM Portfolio 934: Export Tax Incentives (BNA Tax Management, International Series)