ICDISC – FAQ's

1. It is a general feeling amongst the exporters that United States does not offer any tax benefits to exporters, is this true?

   This certainly is not the case. If you look at the history United States has made several attempts to encourage US exports by giving the exporters a tax break. Let me point out that the tax break for exporters is very desirable considering the tax system we have. Basically there are two kinds of tax systems, territorial based and worldwide. US taxes its citizens and residents on their worldwide income; other developed countries taxes their residents on a territorial based system – they tax only the income generated within the borders of their country and often times do not tax income generated by offshore entities. It is easy for them to create offshore entities and do business through them. It has been the US MNCs view that this is not creating a level playing field for them and hence they should get the tax benefits for exporting the goods and services to be able to compete with the other countries. Congress agreed and there started a series of tax benefit provisions in the Internal Revenue Code.

   There is an interesting saga regarding the export tax benefits. In 1971 congress enacted the DISC – Domestic International Sales Corporation in an attempt to stimulate exports. DISC allowed US exporters to allocate certain portion of its export profits to a separate domestic subsidiary known as DISC. This was a little more than a paper corporation. In the mid 1970's major trading partners of US complained that US was providing illegal export subsidy and it was against the spirit of GATT – General Agreement on Tariff and Trade.

   Congress put an end to DISC and enacted FSC – Foreign Sales Corporation provisions in 1984. FSC provisions required the US exporters to establish a foreign corporation that performs certain functions abroad and allows US exporters to claim tax benefit for the sales allocated to FSCs. In practicality the magnitude of these activities was negligible. In 1998 the European Union filed a complaint to the WTO – World Trade Organization that the FSC regime also provided illegal subsidy to the US exporters and was in violation of GATT.

   Hence even the FSC regime was repealed. However, congress made one more attempt and passed the Extraterritorial income exclusion provisions in 2000. However, US could not retain this either and had to shelve the provisions related to export tax benefit.

   However when DISC provision was enacted, another provision called ICDISC was also enacted – this was never challenged or objected to by the trading partners. ICDIC or interest charged domestic international sales corporation still remains in the law as a result unopposed.

2. What are the current ICDISC tax benefits and how do they work? Is it difficult to claim the tax benefits?

   ICDISC or Interest Charged Domestic International Sales Corp was designed as a means by which a US exporter could borrow money from the US Treasury. ICDISC must be a domestic corporation with a single class of stock that has a minimum par value of $2500. More importantly, ICDISC is not subject to the regular corporate income tax and it can also be a related or a subsidiary of the manufacturing corporation.

   Although ICDISC itself is not subject to tax, its US shareholders are subject to tax on deemed dividend distributions from the ICDISC. These deemed dividend distributions do not include income derived from the first $10 million of the ICDISC's qualified exports receipts each year. This means that ICDISC allows its shareholders to defer paying any US tax on the income derived from up to $10 million of its export receipts each year.

   As a charge for deferring to pay any tax, the US shareholder must pay an interest charge on the deferred tax on the ICDISC's export income until the income is distributed by the ICDISC. The interest rate is 52 week Treasury Bills rate which is currently around 0.13%.

   In a common structure, an IC-DISC earns a commission from an affiliated exporter. The exporter pays a commission to the IC-DISC equal to, the greater of 4% of the exporter's qualified export receipts, or 50% of the exporter's taxable income. The exporter deducts the commission payment in full, and the IC-DISC either distributes retained earnings or makes same available for reinvestment back into the export business.

   Properly structured and implemented, the IC-DISC provides the following primary benefits under current law:

   1. <u>Favorable income tax rates</u>: Dividend distributions from the IC-DISC are subject to Federal income tax at the qualified dividends rate of 20%, and thus are not subject to ordinary income tax rates (39.6% currently is the highest marginal individual income tax rate);
   2. <u>Deferral of Income Tax and Increase in Cash Flow</u>: IC-DISC shareholders annually can defer the payment of tax on up to $10 million of net income attributable to qualifying export revenue as long as the corporation reinvests such income in the exporter business; and
   3. <u>Reduction in Employment and Self-Employment Taxes</u>: Dividend distributions from the IC-DISC are not subject to Federal Social Security (FICA), Medicare, or self-employment taxes.

3. Are there any limitations in claiming these benefits?

Well of course. All benefits are subject to certain conditions. It is therefore extremely important to seek professional advice as a small error in compliance can blow away all benefits from the structure.

4. What are the do's and don'ts for maximizing the tax benefits? If you could give clients three pieces of advice when it comes to claiming the export tax benefits, what would that advice be?

   First and foremost, the provisions do provide benefits for exporters. However, it may not be beneficial to all exporters. Therefore, it is advisable to do a little homework prior to embarking on the formation of the ICDISC. For example, choosing the correct method, either the combined taxable income or gross receipts method, depends on the net pre-tax margin.

   As regards to 3 advice, I would say, do your homework first and determine if it would be worth claiming the tax benefits; seek professional advice to make sure that you are maximizing your tax benefits and again consult an experienced accountant so that you can comply with all the provisions under the tax laws. Take away from this – do not ignore this important tax benefit and avail of it while it lasts.

5. How can you assist the exporters so that they comply with the law and still be able to claim the maximum tax benefits? Can you give us an example of how you've helped exporting companies in the past?

6. At CPA Global Tax & Accounting, we start with reviewing the exporters' financial statements and export sales and provide a preliminary assessment of the viability of claiming the ICDISC benefits. If claiming the benefits makes sense, we undertake the formation of the entity and drafting appropriate agreements with the help of the attorney. We then provide ongoing consultation and prepare the ICDISC tax returns.

   It is an interesting story with one of our clients. There are various ways in which you can arrive at the combined taxable income. By grouping certain products and by applying marginal costing method, we were able to increase the net tax benefit from $4 million to $6 million.

The above FAQ's are for general overview only. CPA Global Tax will be happy to provide you appropriate guidance to meet your specific needs. Please contact Pallav Acharya, CPA, CGMA, FCA at pallava@cpaglobaltax.com or at 480-889-8949.