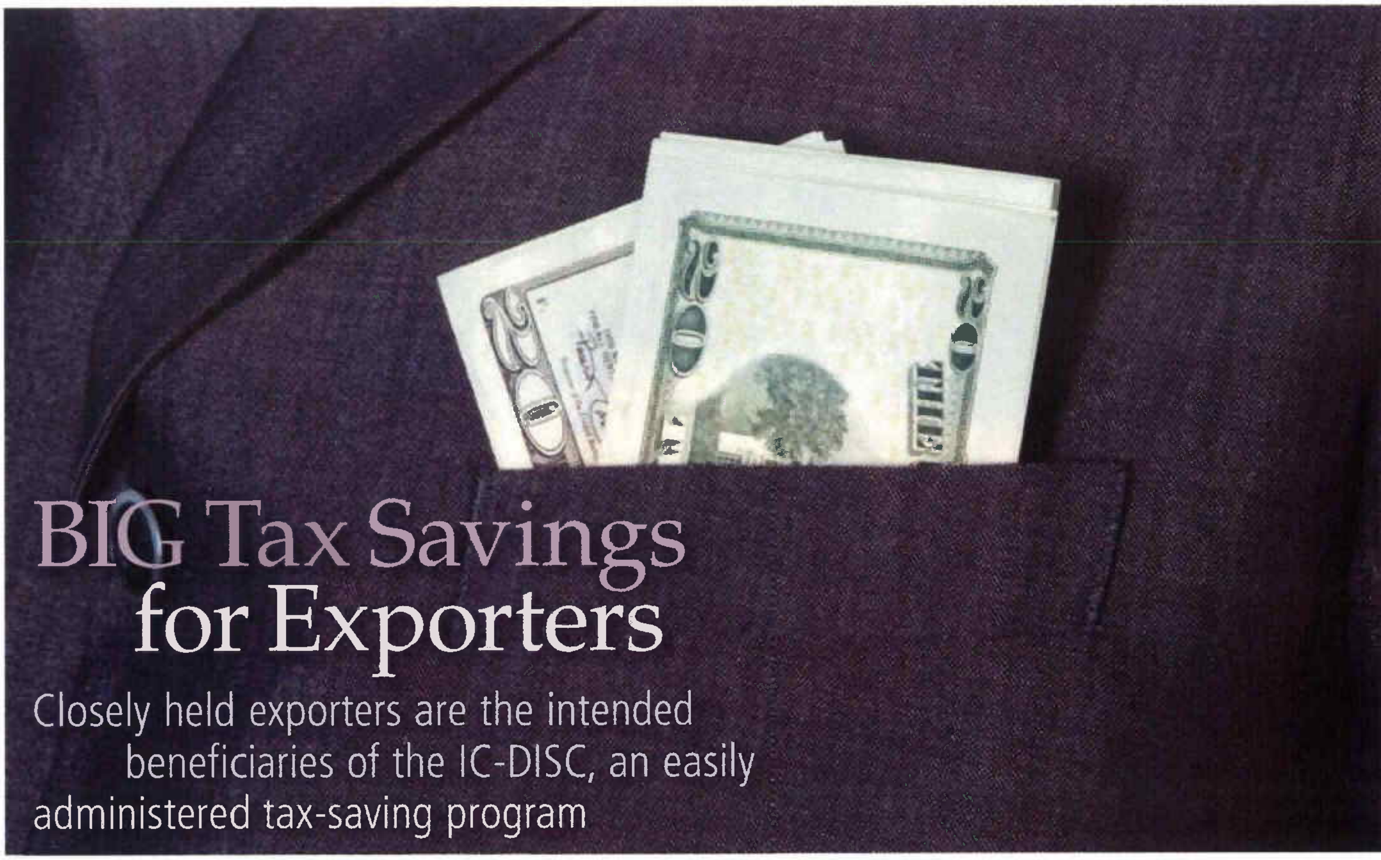

BIG Tax Savings for Exporters

Closely held exporters are the intended beneficiaries of the IC-DISC, an easily administered tax-saving program

Hoping to encourage domestic companies to expand their reach into foreign markets, Congress established the Domestic International Sales Corporation (DISC) — a special tax-advantaged company — back in 1971. While DISC delivered a huge tax payoff to U.S. exporters, our foreign trading partners in Europe successfully pressured Congress to scale back the program.

Congress responded by adding an interest charge to U.S. companies that used the DISC to defer their federal taxes. Hence, we now have an IC-DISC (or Interest Charge-DISC). Due to several recent tax law changes, the IC-DISC has gained renewed attention as a tax incentive that delivers a sizable bang for the buck.

IS IC-DISC FOR YOU?

If you can answer "yes" to the following three questions, there's a good chance you could benefit by establishing an IC-DISC:

1. Does your company sell U.S.-produced products or services outside of the United States?
2. Is your company profitable for tax purposes?
3. Is your company closely held?

The bottom line is that an IC-DISC can reduce income taxes on export sales by 50 percent or more. Businesses that are taxed at the owner level — such as partnerships, LLCs, proprietorships and S corps — can realize a tax reduction of about 30 percent.

HOW DOES AN IC-DISC WORK?

An IC-DISC is a separate U.S. corporation that is generally owned (directly or indirectly) by the same shareholder group that owns your existing company.

Let's consider a hypothetical company called Exportco. With an IC-DISC in place, when Exportco makes an export sale, it calculates a commission using the most favorable of several alternative statutory methods, which is paid to the IC-DISC. Exportco gets a tax deduction for the commission payment, but the corresponding commission income of

Calculating the Savings

Assume Exportco produces one product and has total sales of $50 million, of which $10 million of the sales are exported to foreign customers. The company's manufacturing cost is 60 percent of the selling price and general, administrative and selling expenses are 25 percent of sales, resulting in a pre-tax, pre-commission profit margin of 15 percent.

On the export sales of $10 million, therefore, Exportco generates a pretax profit of $1.5 million. Under Internal Revenue Code Section 994(a), the commission Exportco can pay to a qualified IC-DISC is at least one-half of that pretax profit, or $750,000. So Exportco's taxable income is reduced by $750,000, and the commission is not subject to income tax in the hands of the IC-DISC.

> The time to act is now. President Bush recently signed into law a tax package that extends through 2010 one of the tax benefits that adds substantial muscle to the IC-DISC.

the IC-DISC is not subject to income tax. (See sidebar on page 4 for a detailed computation.)

The amount of the commission is quite substantial. The statutory calculations generally result in a commission that is at least 50 percent of the taxable income derived from the foreign sales — and can be as much as 100 percent of that taxable income.

IRS rules require that the commission actually be paid to the IC-DISC in cash or property. This is a departure from the old Foreign Sales Corporation rules that allowed you to simply make journal entries in the books of the manufacturing company and the FSC. As a result, the IC-DISC program requires some cash management.

Additionally, an IC-DISC is only permitted to have a small amount of cash on hand at year end, and the balance of the IC-DISC assets must consist of "qualified export assets." Without getting too technical, these requirements will result in most IC-DISCs opting to immediately make dividend distributions of the full amount of commission income to IC-DISC shareholders. The IC-DISC dividends will be taxed to shareholders as "qualified domestic dividends," generally subjected to maximum federal income taxes of 15 percent.

Some companies will find that the full distribution of the commission amount to shareholders is too painful a price to pay for even the substantial tax benefits offered by an IC-DISC. These cash flow-sensitive companies will need to avail themselves of one of several allowable strategies to retain all or a substantial portion of the commission amounts in operations. Which capital retention strategy best fits the company will depend largely on the makeup, sophistication and cash flow needs of the shareholder group.

BIG BENEFITS FOR EXPORTERS

The IC-DISC program represents an extremely attractive blend of characteristics that should catch the eye of virtually any successful, closely held exporter of domestically produced goods. Consider the benefits:

- The IC-DISC offers extremely generous tax breaks that usually reduce income taxes on export profits by 50 percent or more.
- It is usable by all types of entities, including partnerships, LLCs, regular corporations and S corps.
- It is relatively easy to understand and administer and is inexpensive to create.
- The tax risk is very low (i.e., this is not an "aggressive" tax shelter).
- Several administrative options are available, adding flexibility to cash management.

The time to act, though, is now. President Bush recently signed into law a tax package that extends through 2010 one of the tax benefits that adds substantial muscle to the IC-DISC.

William Harwood is the director of International Tax Services for Meaden & Moore, Ltd. in Cleveland. He has many years of experience helping U.S. exporters tax advantage of tax incentives like the IC-DISC. You can reach him at wharwood@meadenmoore.com.

COMMON IC-DISC QUESTIONS

Q: Is the IC-DISC program going to be complicated to administer?

A: Not at all. You probably already have experience with the nuts and bolts of the IC-DISC program if you previously used the Extraterritorial Income Exclusion (EIE) and/or the Foreign Sales Corporation (FSC). The IC-DISC uses the same basic calculations as those popular programs.

Q: What if my company is audited by IRS? Is the IC-DISC an aggressive tax strategy?

A: No problem here. The basic program has been a part of the Internal Revenue Code since 1972 and has been available to taxpayers in its current form since 1984. The 50 percent and 30 percent tax reductions noted above are achievable virtually without tax risk. Furthermore, these basic tax benefits can be enhanced, sometimes significantly, through a fuller use of the statutory framework. (However, this benefit enhancement will generally require some judgment calls and potential challenges from the IRS concerning your methods and calculations.)

Q: There must be some costs involved. How much foreign sales volume must we generate to justify use of an IC-DISC?

A: Yes, there are costs — both fixed and variable. These costs are generally in line with the costs of the old FSC program and making claims for EIE deductions. What constitutes sufficient foreign sales volume to generate net benefits will vary from company to company, but an IC-DISC benefit should easily cover costs for companies with annual foreign sales somewhere in the range of $500,000 to $1 million.