PUBLICATION

How an Exporter Maximizes After-Tax Export Earnings With a "DISC"

Authors: John M. Scannapieco
July 25, 2013

Believe it or not, Uncle Sam provides help to exporters on the tax front. The help is in the form of a valuable export tax incentive known as a Domestic International Sales Corporation, or "DISC." The DISC is the only export tax incentive available for U.S. federal income tax purposes. The tax advantages of a DISC mean it is beneficial primarily for small exporters.

The most recent data available from the IRS "Statistics of Income" reflect that 1,917 DISC returns were filed for the 2008 tax year, up from 876 and 1,209 for the 2005 and 2006 years, respectively.[1] From those 2008 DISC returns, approximately 86 percent of all DISC shareholders were individuals or pass-through entities. In addition to U.S. manufacturers (directly exporting or using a U.S. distributor to export), architectural and engineering service providers, distributors of U.S.-made products, and software, film and agricultural products qualify for the DISC incentive.[2]And, after the American Taxpayer Relief Act of 2012 made the qualified dividend tax rate permanent at 20 percent, DISCs are especially advantageous for individual shareholders and/or pass-through entity shareholders.

As long as a small exporter is willing to maintain separate books and records for its DISC, timely file all required tax elections, forms and consents, and adhere to DISC recordkeeping and compliance requirements, the DISC tax incentive is there for the taking.

What is a DISC?

A DISC (really an "IC-DISC," or "interest charge-DISC", more about that below) is a U.S. domestic corporation. It cannot be a manufacturer, but it is usually a subsidiary or affiliate of a U.S. manufacturer or exporter (the DISC's "related supplier"). A DISC is not subject to U.S. federal corporate income tax (although it does remain subject to other taxes, such as employment taxes, and may be subject to state corporate income tax[3]). The DISC's export earnings go untaxed until distributed to shareholders as a dividend.

While the export earnings (of up to $10 million) of the DISC sit tax-free while retained by the DISC, the DISC shareholders are required to pay an interest charge (the "IC" in "IC-DISC") on the DISC tax benefit. The rate is equal to the IRS base period T-bill rate for the applicable taxable year that is published by the IRS for the period ending on September 30 of that year. For 2012, that "IC" rate was 0.16 percent. The interest charge is, in effect, the shareholder's payment to the IRS in return for the ability to defer federal income tax on export earnings.

There are no restrictions on who can be a DISC shareholder, but the DISC may have only one class of stock and must be capitalized with at least $2,500 (of "valid consideration") at par or actual stated value. Individuals, C corporations, S corporations, partnerships and limited liability companies can be DISC shareholders. Although the DISC must be formed as a corporation, it cannot be an S corporation, insurance company, regulated investment company or a financial institution, among other prohibited types of businesses. The DISC also cannot be formed as a limited liability company or other non-corporate entity that elects or "checks-the-box" to be taxed as a C corporation.

A newly-formed (or existing) corporation must formally elect to be taxed as a DISC by timely filing Form 4876-A,"Election to be Treated as an Interest Charge DISC", with the IRS. All shareholders must consent to the election. The IRS strictly enforces DISC election timing requirements.

What Are the Benefits of a DISC and Who Can Benefit?

As detailed below, a DISC may provide the following tax benefits:

1. A deductible commission expense for the DISC's "related supplier"
2. Tax-free treatment of export earnings of the DISC until distributed as dividends to shareholders
3. For individual shareholders, instead of pass-through taxation of export earnings at ordinary income tax rates as high as 40.5 percent, a DISC offers qualified dividend tax treatment for those earnings at rates as low as 20 percent
4. Ultimately, one level of taxation of export earnings
5. Use of DISC export earnings to fund low-cost financing options for the related supplier.

See Exhibit A for an illustration of potential tax benefits provided by a DISC to small exporters.

Those who may benefit from the DISC export incentive include:

6. A manufacturer that exports its products
7. A manufacturer that sells its products to a U.S. distributor or wholesaler that ultimately exports the products
8. A distributor that exports products manufactured in the U.S. by another, related or unrelated, party
9. Architectural and engineering services firms that provide services within or without the U.S. for projects outside the U.S.

In general, an exporter with export gross receipts of $2 million or more is a candidate for a DISC.

The Technical Requirements

As a DISC is a particular "tax animal," there are a number of technical requirements that DISC operations must satisfy. These are:

10. 95 percent of the DISC's receipts must be "qualified export receipts" (QER);
11. 95 percent of the DISC's assets must be "qualified export assets"; and
12. The DISC must maintain its own books and records.

What receipts qualify as QER? These include, among others:

13. Gross receipts from the sale, lease, or license of "export property," and gross receipts from services related thereto;
14. Dividends from a related foreign export corporation;
15. Interest on any obligation that is a qualified export asset;
16. Gross receipts from engineering or architectural services for construction projects outside the U.S.; and
17. Gross receipts for the performance of managerial services in furtherance of the production of other qualified export receipts.

"Export property" is property manufactured, produced, grown or extracted in the U.S. by a party other than the DISC, held primarily for sale, lease or rental in the ordinary course of business by or to a DISC, for direct use, consumption or disposition outside the U.S., and for which 50 percent or less of the fair market value is attributable to articles imported into the U.S. Manufacture or production does not include assembly or packaging. The property must be finished goods and cannot require further manufacture or production outside the U.S.

Intangible property – such as patents, trademarks, most copyrights, models, designs, formulas, goodwill and franchises – does not qualify as export property. A copyrighted article that is not accompanied by a right to reproduce it is export property. A license of computer software, however, should qualify as export property. Most oil and gas products do not qualify as export property.

A DISC's "qualified export assets" are the assets that may remain on a DISC's balance sheet at year end and include accounts receivable, export property and assets (e.g.., inventory), working capital and (temporary) U.S. bank deposits. Another important type of qualified export asset is the "producer's loan." A producer's loan enables the DISC to loan its retained earnings to its related supplier to fund manufacturing. The loan must have a maturity date of five years or less and satisfy other requirements, including an arm's length interest rate and terms.

Using DISCs in Tax Planning

DISCs are a legitimate tax planning vehicle authorized by the Internal Revenue Code.

While a DISC must be a C corporation and may be a subsidiary of a C corporation "parent," it is usually structured as a subsidiary of its pass-through entity related supplier or as a brother/sister company owned by its related supplier's (individual) shareholders.

Although a DISC may be a "buy/sell" DISC, most are set up as "commission" DISCs because the amount of the commission that the related supplier pays to the DISC can be established using one of the safe harbors provided by the Internal Revenue Code. This obviates the need to establish a commission rate using the arm's length transfer pricing rules of the IRS regulations.

The amount of the commission is deductible by the related supplier as an ordinary and necessary business expense and is not subject to federal corporate income tax upon receipt by the DISC. The export earnings (the commission) of the DISC that are retained by the DISC (up to $10 million annually) are also tax-free until actually or constructively repatriated to the shareholder(s). This retention is the taxable income deferral subject to the interest charge (i.e., the tax deferral.) If the export earnings are distributed to individual shareholders or a shareholder that is a pass-through entity owned by individuals, they are taxed as "qualified dividends" subject to the 20 percent qualified dividend rate (plus the 3.8 percent investment income Medicare tax, if applicable to the shareholder). Thus, while those export earnings would be taxed at a top individual federal income tax rate of 39.6 percent (plus the 0.9 percent Medicare tax for a top rate of 40.5 percent), the export earnings of the DISC when distributed to individual shareholders are taxed at a rate of almost half that top rate. In addition, since the DISC is not a taxable entity, there is no double level of federal income tax.

Thus, a DISC could offer significant tax advantages to a small U.S. exporter.

Exhibit A provides an example comparing the general federal income tax consequences for export earnings with and without a DISC.

Conclusion

A DISC is an export tax incentive that is a feasible option for an exporter with export receipts of $2 million or more. Based on IRS statistics, DISCs are growing in popularity. By implementing a DISC, an exporter can achieve tax savings with no impact on operations, customer relationships or markets. As long as the exporter can satisfy DISC technical, recordkeeping and compliance requirements, the tax advantages can be significant.

For more information about setting up or implementing a DISC in your business, please contact your Baker Donelson attorney.

---

[1] Internal Revenue Service, Statistics of Income Bulletin-Summer 2011, "Interest-Charge Domestic International Sales Corporations, Tax Year 2008, p. 116-117.

[2] The top five product or service groups using DISCs were: (1) machinery (other than electrical); (2) electrical machinery, equipment and supplies; (3) fabricated metal products (other than ordnance, machinery, and transportation equipment); (4) chemicals and allied products; and (5) a tie between primary and secondary nonfabricated metal products and transportation equipment. Professional, scientific and controlling instruments were a close sixth. Id. at 118, 120.

[3] For example, while Georgia, South Carolina and Florida conform to the federal tax treatment of DISCs, Louisiana, Mississippi, North Carolina, Tennessee and Virginia do not and treat DISCs as regular taxable corporations.