Interest Charge Domestic International Sales Corporations - *The remaining exporter tax benefit*

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Abstract

This article provides a brief history of the tax breaks given to exporters and explains how the Interest Charge Domestic International Sales Corporation is the last benefit remaining to exporters. A code section by code section analysis of the Interest Charge Domestic International Sales Corporation tax law is provided. The article then explains what an Interest Charge Domestic International Sales Corporation is and how to use one to save on Unites States taxes. The article provides examples of the ways the Interest Charge Domestic International Sales Corporation can save taxes through setting up a sales transaction or a commission transaction. The article concludes with a brief discussion of the case law surrounding Interest Charge Domestic International Sales Corporation.

Introduction

Until the 1970, the United States economy was largely a "net exporter"[1] as the U.S. economy was dominant at the time, and the real competition for foreign imports was not significant. However, beginning in 1971, this position began to change dramatically as global trade expanded rapidly, along with the U.S. trade deficit (see Exhibit 1). After increasing to a peak deficit of $753 Billion, the recent economic slowdown lowered the deficit to $381 Billion for 2009, the lowest since 2001, as the U.S. economy simply consumed less. Since that time, the deficit again grew to $557 Billion in 2011, before shrinking a bit to 535 billion in 2012. The most current month (June 2013, see Exhibit 2) showed a negative trade balance of $34.2 Billion[2]. It is interesting to note however, in this data since about the time that the U.S. began operating in a net trade deficit, it has been focused in "goods" while the country continues to expand a positive trade balance in "services." This truly illustrates the dynamics in the development of the U.S. and world economies.

Because of this growing trade imbalance, the United States, since The Revenue Act of 1971 has attempted to encourage U.S. companies to export goods (as well as certain services) via a host of tax benefits. However, with the growing world economies and various trade agreements and treaties that had been entered into through the years, most of these benefits have been successfully challenged by foreign partners and subsequently removed from the tax laws. After a series of challenges and indirectly beneficial changes to the U.S. tax code, there is one major benefit that remains to U.S. exporters, the Interest Charge Domestic International Sales Corporation ("IC-DISC").

As will be discussed, an IC-DISC is not a taxable entity[3] and was created to allow an exporter to essentially defer a portion of income at a low interest charge. However, more recently with the Jobs and Growth Tax Relief Reconciliation Act of 2003 allowing dividends to be taxed at the

[1] U.S. Census Bureau, Foreign Trade Division. U.S. Trade in Goods and Services – Balance of Payments Basis. August 12, 2013.

[2] U.S. Census Bureau, Foreign Trade Division. U.S. International Trade in Goods and Services Highlights. August 12, 2013.

[3] I.R.C. §991

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capital gains rate[4] (and subsequent extensions of this benefit) the effect is essentially an immediate 20% or 15% tax savings for S-Corp exporters and even greater benefit for closely held C-Corp owners, as double taxation is avoided (as long as the IC-DISC abides by the necessary regulations).

The primary purpose of this article will be to provide a summary of the current tax benefit that exists for exporters with an IC-DISC, and how to take advantage of them. This cannot be done without first giving a history of export tax credits, as well as other tax decisions that have been made throughout the years. This is an important step because it truly illustrates how the worldwide nature of our economy, even dating back to the 1970's, has had a dramatic effect on how Congress shapes the tax code, and on how companies must also adapt to these changes over time. Also, the analysis of the IC-DISC, and history of exporting tax benefits will help pose some analysis that will be necessary in evaluating taking advantage of this benefit.

I History of Legislation and Exporter Benefits

A Establishment of the DISC

The initial Domestic International Sales Corporation ("DISC") legislation was actually established in 1971, right around the time the U.S. began to see its trade surplus move to a deficit. With this legislation, Code Section 991 was established, exempting the DISC from taxes. The DISC could essentially "defer" taxes until the money was paid to its shareholders, or other events occurred. [5] In practice however, the DISCs would never actually pay a dividend, but would lend the money back to the operating company. The lack of dividend payment would essentially create a permanent deferral of these taxes[6].

The new DISC creation was quickly challenged by foreign countries as a violation of the General Agreement on Tariffs and Trade (GATT) as an impermissible trade subsidy. The initial ruling came in 1976 against the DISC setup, and then after various challenges the final ruling came in 1981 against the DISC treatment. In reaction to the elimination of the DISC benefit the United State took two steps in revising the tax code and laws.

B 1984 Legislation Reaction

One of the steps that the U.S. took after the GATT decision was to establish Foreign Sales Corporations ("FSC"). These FSC's were created to allow companies to exclude a portion of the income from exporting goods from the United States. These were designed in a way that the U.S. expected them to be upheld against fair trade challenges.

More Importantly for the purposes of this discussion, Congress did not fully repeal the DISC regulations, but they did make two key modifications to the law. The first is the limit on tax deferral to $10 million of a DISC's export receipts. Any amount above this $10 million is

[4] Jobs and Growth Tax Relief Reconciliation Act of 2003 §302
[5] Public Law 92-178, 1971. Title V
[6] History of Export Tax Benefit Legislation. Export Assist. http://www.exportassist.com/tax_history.html. Retrieved 11/23/2011.

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deemed as immediately distributed, and the shareholders of the DISC are charged taxes, even if the cash has not changed hands.[7]

The second modification was adding an interest charge due on the amount of deferred income.[8] Essentially, this interest charge due to the treasury at the base T-Bill rate[9] disallows permanent free deferral of the income without distribution. This interest charge on the deferred tax liability is what garnered the "IC" addition to DISC's formed after 1984. Once the income from the DISC is distributed, there is no longer a deferral, as the shareholders of the DISC will be paying taxes on that distribution, so no interest charge is due.

It was in 1997 and into 1998 that the European Union brought a challenge to the FSC set-up, again challenging it in relation to the evolving GATT regulations. In 1999, it was concluded that the FSC was in violation of these agreements; it was repealed in 2000 with the FSC Repeal and Extraterritorial Income Exclusion Act of 2000.[10] However, it is important to note that with this challenge to FSCs there was no challenge to the IC-DISC and these regulations were retained.

C Extraterritorial Income Exclusion Act and Important Effects

Outside of repealing the FSC, the Extraterritorial Income Exclusion Act ("ETI") included another way for exporters to exclude certain "qualifying foreign trade income."[11] This was almost immediately challenged by the EU and World Trade Organization as a further violation of GATT. In 2002, the trend continued as the ETI was determined to be an illegal trade subsidy.

After some time, and even sanctions from the E.U. due to lack of action, the ETI was ultimately repealed in 2004 with The American Jobs Creation Act of 2004. The act included certain phase out rules that eventually fully phased out the ETI in 2006.[12]

Outside of the ETI being repealed, the Jobs Creation Act of 2004 established another important piece of tax legislation for a U.S. based business. The "domestic production activity" deduction phase in was established with this law.[13] By establishing the internal revenue code Section 199, U.S. based businesses, including exporters, can essentially provide themselves with a 9% deduction (after full phase in from 2010 on) on qualifying income, and subject to certain restrictions.[14] The domestic production activity deduction was essentially created as a compromise as it applies to all U.S. producers, and does not single out exporters. Even if an exporter is taking advantage of the benefits of the IC-DISC, domestic production activity deduction remains a valid deduction to be taken.

Again, with this act in 2004 the DISC rules remained unchanged.

D Other Important Legislation

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[7] I.R.C. §995(b)(1)(E)
[8] I.R.C §995(f)
[9] I.R.C §995(f)(1)(B)
[10] The FSC Repeal and Extraterritorial Income Exclusion Act of 2000 §2
[11] The FSC Repeal and Extraterritorial Income Exclusion Act of 2000 §3
[12] The American Jobs Creation Act of 2004 §101
[13] The American Jobs Creation Act of 2004 §102
[14] I.R.C 199

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Outside of the specific export legislation, there are a couple of additional important pieces of legislation that require attention for the historical background. As mentioned above, the first and most important of these acts was the Jobs and Growth Tax Relief Reconciliation Act of 2003 (GTRRA) that reduced the corporate dividends paid to individuals to the 15% rate.[15] Initially, this provision was set to expire as of December 31, 2008. However, in 2005, Congress passed the Tax Increase Prevention and Reconciliation act of 2005. With this act, the beneficial treatment of dividends to individuals was extended until December 31, 2010.[16] More recently, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 was passed and further extended this benefit until December 31, 2012.[17] Finally, the American Taxpayer Relief Act of 2012 extended the treatment of Dividends.[18] This act also established a 20% tax rate for Capital gains and dividends for tax payers with incomes above $400,000 for individuals, $425,000 for Head of Household, and $450,000 for Married Filing Jointly.[19]

As has been noted before, the reduction in tax rate of dividends in the GTRRA and the subsequent extensions are the primary drivers to the IC DISC benefit. The American Taxpayer Relief Act of 2012 makes this reduction permanent. As Congress looks toward a "Grand Bargain" to lower tax rates and eliminate many tax breaks it is possible that the tax rate on dividends will go up. Should congress increase the tax rate on dividends, the IC DISC will continue to provide some deferral benefits; however, the most significant benefits that the IC-DISC provides would be eliminated.

II IC-DISC Regulations

The modern day IC-DISC is governed by Internal Revenue Code §§ 991 – 997. The following sections will delineate the legal aspects of an IC-DISC, the qualifications, etc. before getting to some examples of the tangible benefit that IC-DISCs can create. In these sections, please refer to the subheading as references. Versus citing each example all of the following are taken from the tax code sections and applicable regulations unless otherwise noted. Also, from this point on, as the DISC to IC-DISC evolution has been explained, the terms DISC and IC-DISC will be used interchangeably (the tax code still refers to the entities as a DISC).

A IRC § 991

Code Section 991 is only one sentence, but it is a relatively powerful one. "For the purpose of the Taxes imposed by this subtitle upon a DISC (as defined in section 992(a)), a DISC shall not be subject to the taxes imposed by this subtitle." As this regulation is included in the "Subtitle A – Income Taxes" it is essentially a long way of saying that qualifying DISC entities are not subject to income taxes at the entity level.

B IC-DISC Ownership

Before delving further into the regulations, there is a quick note about ownership of an IC-DISC. The most advantageous set-up for an IC-DISC is to have the individual shareholders of the

[15] Jobs and Growth Tax Relief Reconciliation Act of 2003 §302
[16] Tax Increase Prevention and Reconciliation act of 2005 §102
[17] Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 §102
[18] American Taxpayer Relief Act of 2012
[19] American Taxpayer Relief Act of 2012

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primary producing entity also personally own the IC-DISC, versus the actual entity owning the DISC. This is important to take full advantage of the favorable dividend rate, and the distribution strategy that will be discussed later. It is assumed through the following discussions that the ownership of the exporter and DISC are related in this manner.

C IRC § 992

Code Section 992 goes on to further define what qualifies a company as a DISC. There are four primary qualifications that a DISC must meet to qualify under these regulations. These are:

1) 95% Qualified Gross Receipts Test - meaning that 95% or more of the gross receipts must be qualified export receipts (to be defined in §993);
2) 95% Qualified Gross Assets Test – meaning that 95% of the total corporation's assets must be qualified export assets (to be defined in §993);
3) It must have only one class of stock with a minimum total par value of $2,500;
4) The corporation must make an election to be treated as a DISC.

The IC-DISC must elect to be treated as such by filing form 4876A 90 days before the beginning of the tax year, and is able to revoke the status during the first 90 days of the tax year. This section also spells out the ways for a corporation to get back into compliance should the DISC fail to meet the asset or receipt tests. This requires distribution of the funds necessary to gain compliance, as well as defining a "reasonable cause" for non compliance.

A final point to be made on §992 is the list of "ineligible corporations." Of the 7 ineligible corporations, the primary notable is the last which is "an S corporation." The IC-DISC itself must be organized as a C-Corporation. Due to the requirement to distribute profits to make the DISC a taxable entity, this is an important elimination. The primary producing and export entity may be organized as any type of entity, and the owner of the DISC may be any type of organization or an individual.

D IRC §993

Code Section 993 goes into further depth on defining what qualified export receipts and export assets are for the purpose of the 95% tests.

There are 8 different types of qualified export receipts. These range significantly from simple gross sales from sale, exchange, or disposition of export property, receipts for services on qualified sales, specified qualifying interest and dividends, engineering and architectural services outside of the U.S., and an important allowance for the performance of managerial services. This essentially allows the DISC to not complete significant actions, but collect a commission (as calculated in the next section). This section also notes the excluded receipts. These definitions are explained and defined in Regulation §1.993, which provides further clarity such as required time frames that payments must be made (such as commission payments within 60 days of the tax year close).

As far as the qualified export assets, there are 9 varying qualifications. The most broad and important of these is the first, which includes "export property" that is defined as follows:

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1) Manufactured, produced, grown, or extracted in the U.S. by a person other than the DISC;

2) Held by or to a DISC for primary consumption or disposition outside of the U.S.;

3) Not more than 50% attributable to articles imported into the U.S.

In addition to this, there are other assets which one would expect to be included such as, accounts receivable, reasonable working capital requirements, etc. Regulation §1.993 again provides further delineation. One such delineation, § 1.993-2(d)(2) allows for the commissions received to be included as a qualifying asset. This section also notes excluded assets, which interestingly enough also can include property that the President determines is in "short supply."

Another importation delineation in §993(d) is the determination of Producer's Loans. In effect, this section allows for the DISC to loan its accumulated (undistributed) income back to the primary operating company / exporter, while still deferring the income from taxes, as it has yet to be distributed. There are some general restrictions or limitations that are calculated within this subsection. These loans do also qualify as an export asset and the interest income is a qualified export receipt, although the interest is immediately "deemed distributed," as will be discussed later. These producers' loans are more important if the income of the DISC is not distributed and deferred, however, the current environment may not make this the most advantageous treatment of the DISC.

E IRC §994

Code Section is another relatively short section on a standalone basis, although the supportive regulations in §1.994-1 are significantly detailed. In general, §994 spells out the way that a DISC can record and calculate its income. The taxable income of will be based on a price (regardless of actual prices charged) to result in income which does not exceed the *greatest* of:

Determination #1:

4% of the qualified export receipts on the sale of such property by the DISC, plus 10% of the qualifying export promotion expenses to the DISC, or;

Determination #2:

50% of the combined taxable income of the DISC and the person which is attributable to the qualified export receipts as a result of the sale by the DISC, plus 10% of the qualifying export promotional expenses to the DISC, or;

Determination #3:

Taxable income based on the sales price actually charged (but subject to the rules provided in §482).

Additionally, §994 allows for regulations to be determined to further delineate these applications in the case of commissions and expenses that are consistent with the above, and these are spelled out in Regulation §1.994-1. In the regulation, it notes the DISC does not have to perform substantial economic function to apply the sections 1&2 above. In the examples that follow, a

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commission payment is made using the same determination as above, but no actual sale is made by the DISC as implied in the code. Also, §994 further defines the export promotion expenses noted above.

Another important distinction of application of these rules is the "no loss" rule in the regulations under §1.994-1(e), which limits the DISC benefit. In its most simple application, in the use of a DISC, the commission or transfer price (in the case of an actual sale to the DISC) may not create a combined loss on the product when the direct costs to the producer and DISC are considered together. Along this line, it should be noted that §267(f)(3)(A) does specifically eliminate a DISC from the definition of a "controlled group" allowing the deduction of the expenses between related parties in the DISC transaction, which otherwise would be essentially a stepped transaction to specifically avoid taxes.

The code section 482 noted above (Determination #3), is prevalent in the DISC rules, as this section along with its regulations, sets forth the determination of arms length prices, etc. It also allows the I.R.S. to re-distribute income and other items among related parties if it determines transactions were made simply to evade taxes. In the case of Determination #3, the sales price and IC-DISC income calculation may be subject to further audit scrutiny if they allow for a greater deduction than the first 2 prescribed methods.

F IRC §995

This section is the one that ultimately discusses the taxation of the DISC income and its distribution to shareholders. For practical reasons, the current tax environment incents the IC DISC to distribute its income immediately to shareholders. However, if a distribution is not paid, there are some factors that limit the amount of deferral that the DISC can create. The limitations force income to be "Deemed Distributions" even if no dividend is paid. These include various items, among other things, interest from producer's loans and any taxable income in excess of $10,000,000, essentially eliminating any deferral benefit over the $10 million cap and focusing on "smaller" exporting enterprises. The section also discusses immediately deemed distributions of illegal or boycotted country income. Additionally, if the shareholder is a C-Corp, 1/17 of the income is deemed distributed immediately. Also, included in this section are rules on how the deferred income is to be treated if the DISC is no longer treated as a DISC or revokes its status.

Section f of 995 also provides the all important "Interest Charge" that garners the IC-DISC its name. Essentially, the regulation states that for any tax year, the shareholder of a DISC pays the amount of its DISC related deferred tax liability (times) the base period T-Bill rate (the 1 year constant maturity Treasury yields - currently 0.11%).[20] For 2012, this was 0.16%[21]

G IRC §996

Section 996 is used to illustrate the ordering of distribution treatment, losses, and basis.

[20] http://www.bankrate.com/rates/interest-rates/treasury.aspx retrieved August 12, 2013
[21] Revenue Ruling 2012-22

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H IRC §997

Section 997 is again a short section, which has special meaning for C-corporations. In the case of a C-corporation that owns a DISC (versus an individual or a pass-through entity), the distributions are treated the same as if the distribution were made to an individual, and have that same basis in the hands of the recipient corporation. This regulation essentially eliminates the "dividends received deduction" as the income at a DISC is already tax free and not subject to the double taxation issue.

An additional issue with corporations and the DISC benefit is addressed elsewhere in the code under §1504(b)(7) which disallows the inclusion of a DISC in a consolidated return, again eliminating the possibility of total tax avoidance on the DISC income.

I **Summary**

As seen even in this brief summary, though the DISC is simple in theory, there are hundreds of pages of regulations that support the DISC, its proper usage, and limitations. Also, hopefully the benefit of the DISC is evident, providing the possibility for significant income deferral from taxes at a low interest rate. Also, with the current dividend rate environment, the deferral is a secondary benefit compared to the savings from immediate distribution. Following are brief examples of how to use the IC-DISC and calculate its current benefits.

III Examples of IC-DISC Application

As mentioned earlier, the rules on how an IC-DISC is applied and its limitations are numerous, but the brief oversimplified examples below will give a basic understanding on how a sales transaction or a commission transaction would work. There are various other items, such as allowing the DISC to have supporting promotional expenses that could increase the deferral; however there is significant law built around this that would add significant detail and necessary understanding to properly apply.

A *Sales Transaction*

Company X – Domestic Entity that produces an export product

Company Y – IC-DISC entity owned by the shareholders of Company X

In this example Company X would sell a product to Y at a determined fair price of $800; assume X's input costs are $700. Then Company Y would perform further substantive actions at a cost of $200 and then ultimately sell the good for export at the cost of $1,000.

To compute the maximum profit that the DISC entity may earn you must first compute the combined income, as the profit at the DISC may not exceed this amount:

Y Sales Price	$1,000	
-X Cost		$700
-Y Costs		$200
Combined Income		$100

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The profit at the DISC will be the highest of the 3 determinations, assuming the amount would not create a combined loss. Here are those calculations:

50% of the combined taxable income: 50% * $100

DISC Income **$50**

4% of the gross receipts method: 4% * $1,000

DISC Income **$40**

Section 482 Method:

Y Sales Price	$1,000
-Cost of Goods Sold (Price Paid)	$800
-Additional Expenses (Y)	$200
Y Profit	**$0**

Since the 50% method does not exceed the combined income, the transfer price that is recorded by X may be adjusted as long as it is not below $750, computed as follows:

Y Sales Price	$1,000
-Y Expenses	$200
-Y Profit	$50
Total Subtractions	$250
Transfer Price	$750

The effect of this adjustment, allows the DISC to record $50 of the income, while reducing the producing entity's income by $50. This essentially would create a deferral of that $50, as that income would be recorded at the DISC, versus holding all of the costs at Company X and not utilizing the DISC. This is illustrated here:

Company X Sales (Transfer) Price	$750	
-Company X Expense	$700	
Total Company A Taxable Income	$50 (versus initial $100)	
Company Y Sales Price		$1,000
-Transfer Price from X		$750
-Additional Costs at Y		$200
Total Y Deferred DISC Income		$50

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B Commission Transaction

Company A – Domestic Entity that produces an export product

Company B – IC-DISC entity owned by the shareholders of Company A

In this example, Company A produces a good then sells the product at a qualifying export price of $1,000. Assume the direct cost (COGS and direct selling expenses) for A to produce these goods are $900. Company B is set up as an IC-DISC performing no substantive action other than collecting the commission related to the export sale.

Again, as before you must begin with the calculation of total income:

Company A Sales Price	$1,000
-Company A Expense	$900
Total Income	$100

Also, you must still determine the income allowable to the DISC:

50% of the combined taxable income: 50% * $100

DISC Income **$50**

4% of the gross receipts method: 4% * $1,000

Disc Income **$40**

Section 482 Method:

The section 482 Method would not apply here for a commission, as the 482 method only applies when the related supplier (Company A) had sold the property to the DISC and the DISC then subsequently sold the property to a third party to determine a fair price.[22]

Since the 50% method again produces the larger of the two incomes and does not create a combined loss, it may be deducted as a commission at Company A and produce income of the same amount for the DISC, Company B, as follows:

Company A Sales Price	$1,000
-Company A Expense	$900
-IC DISC Commission	$50
Total Company A Taxable Income	$50
Company B DISC Commission	$50

[22] Federal Tax Regulation §1.994-1(d)(2)

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The result of this transaction is a valid deduction of $50 at the Company A level, reducing the immediate taxable income, and tax deferred income of $50 at the IC-DISC level.

C Tax Savings Calculations

The above calculations both show a tax deferral of $50 for the exporter, and $50 of income for the IC-DISC. As noted before, the IC-DISC has the option to retain these funds at an interest charge to the treasury. In this case, assuming a general 35% rate, the savings would have an immediate effect of $17.50 of tax savings for the current year ($50 * 35%) with the time value of money theoretically creating the remaining benefit and offsetting the interest charge. The possible changes in future income rates do provide some uncertainty.

However, as presented earlier, with the evolution of the dividend laws, there can be a much greater benefit than just deferral. Recent legislation has made the calculation of the benefit more complicated. Below is a calculation that essentially shows that versus deferring taxes, there is an immediate benefit that can be garnered by paying out the dividend. This calculation assumes a single taxpayer with AGI no higher than $200,000, or a married couple with AGI no more than $250,000.

Corporate Tax Savings (35%*$50) $17.50

Dividend Tax Paid by Owner (15%*$50) $7.50 (assuming all $50 of DISC income is distributed)

Total Immediate Benefit $10 (20% of original $50)

As noted, this benefit is immediate and eliminates uncertainty of future tax rates, etc. that deferral may be exposed to.

For single taxpayers earning in excess of $200,000, married couples earning more than $250,000 net investment income is subject to an additional 3.8% tax. Single taxpayers with AGI in excess of $400,000, married couples filing jointly AGI in excess of $450,000.the capital gains rate is now 20%. For the rest of this paper all calculations will assume taxpayers with AGI of $200,000 or less, but for taxpayers with higher AGIs the rates are higher and the benefits are lower.

D C-Corp vs. S-Corp

The above example essentially calculates the benefit as if the exporting entity was a privately held S-Corp and the DISC has related individual ownership (corporation and dividend are recorded on the same return). The effect of a DISC in this case is an immediate 20% tax gain. As both the dividend income and any remaining entity income would flow through to a personal return, the IC-DISC would not lower AGI, but would effectively reduce the tax rate.

It should be noted that in the case of a C-Corp, the effect is similar, however because of the double taxation, the savings is essentially 30%. In theory, the profit of $50 would be taxed first at the corporate rate (assume 35%), then a distribution of the remaining profits would again be

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taxed at 15%. This creates an effective tax rate of 44.75%. Compare this to the single taxation of 15% on the DISC deduction; there is a 29.75% savings in this example.[23]

If your primary exporting entity was formed as a C-Corp, there is theoretically a more significant tax benefit, there are obviously many other factors should play into the choice of business entity.

E Real World Effects

Theoretically, the DISC provides an easy way for nearly immediate tax savings. As the benefit is dependent on payment of a dividend, the cash flow concerns are real. In the examples above, approximately half of the producing company's net income was expensed in the IC-DISC (and would ultimately have to be distributed). For strong companies, this may be possible; however, when this strategy is put into practice, it does raise concerns such as maintaining creditor covenants, as well as retaining enough cash in the company to sustain operations and growth.

As noted the regulations do provide for such items as "Producer's Loans" which allow the DISC to lend the deferred funds back to the primary entity, while retaining the tax deferral. Much of the benefit results from the lower dividend rates. While congress recently made the lower dividend rates permanent there is consistent talk about rewriting the IRC, a so called "Grand Bargain.' It is possible that the dividends rate will be part of the bargain. If dividends are once again taxed at ordinary tax rates the benefit of immediate distribution to receive lower dividend tax rates will no longer apply.

IV Case Law

A search of IC-DISC related case law, did not show any real challenge to the benefit that can be garnered from the DISC regulations. However, it did provide for some very important warnings for companies looking to take advantage of the DISC.

For instance, all of the discussion that has preceded this is an analysis of *Federal* tax laws and regulations. Each state may or may not allow the DISC deduction in the calculation of that jurisdiction's taxable income. There were many cases of individual states challenging company's returns for a deficiency after taking a deduction for the DISC. This was evident in a Kentucky case of Armco, Inc. Here, Armco argued that since Federal Law encouraged trade through the DISC, the state should also be bound by this as they have an interest in encouraging trade this as well. Based on this argument, they used the gross income determinations of the Federal Tax Code for apportionment, etc. As Kentucky has not adopted the Federal IC-DISC regulations, Armco was required to pay taxes on the combined income, and was not allowed the DISC deduction.[24]

The second primary reason for cases brought by the commission against IC-DISCs are due to qualifying circumstances, such as lack of adherence to the various detailed regulations. Again, this simply shows the importance of understanding what the rules and regulations are, and adhering to the necessary requirements. An example of this is the case of Boeing, which made it

[23] Misey, Robert R. Jr. *Tax-Advantaged Planning for Closely Held Exporters-Return of the IC-DISC*. Taxes- The Tax Magainze. July, 2006
[24] Armco Inc. v. Revenue Cabinet, Commonwealth of Kentucky. Supreme Court of Kentucky, No. 87-SC-331-DG, 748 S.W. 2d 372, March 3, 1988.

all the way to the United States Supreme Court, as they affirmed the misallocation of R&D funds in the calculation of combined taxable income, increasing the deferral.[25] Boeing paid the tax initially and then challenged it, but was denied the refund request.

Finally, most of the case law revolved around pre-1984 law, as well as FSC's, which are no longer available. Overall, the case law shows the need to properly apply the complex regulations.

V Conclusion

The I.R.S. reported in 2008 there were 1,917 IC-DISC returns filed, up steadily from a low of 425 filed in 2004.[26] This is not a surprising rise based on the 2003 dividend benefit and subsequent extension in 2005. A more recent business week article reported about 6,000 businesses taking advantage of the benefit.[27] Even considering these statistics, it appears as if it is a tremendously under used benefit as according to the International Trade Administration, there are over 275,000 identified U.S. exporters.[28]

As noted in the introduction, the primary purpose of this paper was to show how the IC-DISC came about, and how much of a significant advantage can be garnered from it. Based on the analysis, it seemingly provides an immediate tax advantage on a specified amount of income of 20%+. However, this benefit comes with two major caveats. First, there is a significant amount of detailed law, and though at its heart it is a simple deduction, attention to detail is needed. This includes jurisdictional awareness, so you can treat the DISC properly at all levels. Secondly, exporter benefits are extremely vulnerable to legislation, here and abroad. It is important to be aware of the current laws in relation to the DISC, the dividend rate, and international challenges to the benefit.

There is clearly a risk of this benefit going away, as the continual extension of the favorable rate has continued to be challenged before ultimate extension. Also, if any special dispensation is made for DISC's when or if the dividend law is reversed there is risk of international challenge as that would separate the DISC out again and make it a special case, similar to the previous export laws.

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[25] The Boeing Company and Consolidated Subsidiaries, Petitioners v. United States. U.S. Supreme Court; 01-1209, 01-1382, 123 SCt 1099, March 4, 2003, 537 US 437, 123 SCt 1099.
[26] Statistics of Income Bulletin, Summer 2011. Interest-Charge Domestic International Sales Corporations, 2008.
[27] Zerbe, Dean and Young, Jim. *Save the IC-DISC Export Tax Break.* Business Week. http://www.businessweek.com/smallbiz/content/jul2010/sb20100726_149647.htm. Retrieved November, 27 2011.
[28] Smaller Companies Have Vast Untapped Export Potential. http://trade.gov/cs/factsheet.asp. Retrieved December 8, 2011.

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Exhibit 1

June 4, 2013

U.S. Trade in Goods and Services - Balance of Payments (BOP) Basis

Value in millions of dollars
1960 through 2012

Period	Balance			Exports			Imports		
	Total	Goods BOP	Services	Total	Goods BOP	Services	Total	Goods BOP	Services
1960	3,508	4,892	-1,384	25,940	19,650	6,290	22,432	14,758	7,674
1961	4,195	5,571	-1,376	26,403	20,108	6,295	22,208	14,537	7,671
1962	3,370	4,521	-1,151	27,722	20,781	6,941	24,352	16,260	8,092
1963	4,210	5,224	-1,014	29,620	22,272	7,348	25,410	17,048	8,362
1964	6,022	6,801	-779	33,341	25,501	7,840	27,319	18,700	8,619
1965	4,664	4,951	-287	35,285	26,461	8,824	30,621	21,510	9,111
1966	2,939	3,817	-878	38,926	29,310	9,616	35,987	25,493	10,494
1967	2,604	3,800	-1,196	41,333	30,666	10,667	38,729	26,866	11,863
1968	250	635	-385	45,543	33,626	11,917	45,293	32,991	12,302
1969	91	607	-516	49,220	36,414	12,806	49,129	35,807	13,322
1970	2,254	2,603	-349	56,640	42,469	14,171	54,386	39,866	14,520
1971	-1,302	-2,260	958	59,677	43,319	16,358	60,979	45,579	15,400
1972	-5,443	-6,416	973	67,222	49,381	17,841	72,665	55,797	16,868
1973	1,900	911	989	91,242	71,410	19,832	89,342	70,499	18,843
1974	-4,293	-5,505	1,212	120,897	98,306	22,591	125,190	103,811	21,379
1975	12,404	8,903	3,501	132,585	107,088	25,497	120,181	98,185	21,996
1976	-6,082	-9,483	3,401	142,716	114,745	27,971	148,798	124,228	24,570
1977	-27,246	-31,091	3,845	152,301	120,816	31,485	179,547	151,907	27,640
1978	-29,763	-33,927	4,164	178,428	142,075	36,353	208,191	176,002	32,189
1979	-24,565	-27,568	3,003	224,131	184,439	39,692	248,696	212,007	36,689
1980	-19,407	-25,500	6,093	271,834	224,250	47,584	291,241	249,750	41,491
1981	-16,172	-28,023	11,851	294,398	237,044	57,354	310,570	265,067	45,503
1982	-24,156	-36,485	12,329	275,236	211,157	64,079	299,391	247,642	51,749
1983	-57,767	-67,102	9,335	266,106	201,799	64,307	323,874	268,901	54,973
1984	-109,072	-112,492	3,420	291,094	219,926	71,168	400,166	332,418	67,748
1985	-121,880	-122,173	294	289,070	215,915	73,155	410,950	338,088	72,862
1986	-138,538	-145,081	6,543	310,033	223,344	86,689	448,572	368,425	80,147
1987	-151,684	-159,557	7,874	348,869	250,208	98,661	500,552	409,765	90,787
1988	-114,566	-126,959	12,393	431,149	320,230	110,919	545,715	447,189	98,526
1989	-93,141	-117,749	24,607	487,003	359,916	127,087	580,144	477,665	102,479
1990	-80,864	-111,037	30,173	535,233	387,401	147,832	616,097	498,438	117,659
1991	-31,135	-76,937	45,802	578,344	414,083	164,261	609,479	491,020	118,459
1992	-39,212	-96,897	57,685	616,882	439,631	177,251	656,094	536,528	119,566
1993	-70,311	-132,451	62,141	642,863	456,943	185,920	713,174	589,394	123,780
1994	-98,493	-165,831	67,338	703,254	502,859	200,395	801,747	668,690	133,057
1995	-96,384	-174,170	77,786	794,387	575,204	219,183	890,771	749,374	141,397
1996	-104,065	-191,000	86,935	851,602	612,113	239,489	955,667	803,113	152,554
1997	-108,273	-198,428	90,155	934,453	678,366	256,087	1,042,726	876,794	165,932
1998	-166,140	-248,221	82,081	933,174	670,416	262,758	1,099,314	918,637	180,677
1999	-263,755	-337,374	73,618	967,008	698,218	268,790	1,230,764	1,035,592	195,172
2000	-377,337	-446,942	69,605	1,072,782	784,781	288,002	1,450,119	1,231,722	218,397
2001	-362,339	-422,512	60,173	1,007,725	731,189	276,537	1,370,065	1,153,701	216,364
2002	-418,165	-475,842	57,678	980,879	697,439	283,440	1,399,044	1,173,281	225,762
2003	-490,545	-542,273	51,728	1,023,937	729,816	294,121	1,514,482	1,272,089	242,393
2004	-604,897	-666,364	61,466	1,163,724	821,986	341,739	1,768,622	1,488,349	280,272
2005	-707,914	-784,133	76,219	1,288,257	911,686	376,571	1,996,171	1,695,820	300,352
2006	-752,399	-838,788	86,389	1,460,792	1,039,406	421,386	2,213,191	1,878,194	334,998
2007	-699,065	-822,743	123,677	1,652,859	1,163,605	489,255	2,351,925	1,986,347	365,577
2008	-702,302	-833,957	131,655	1,840,332	1,307,329	533,003	2,542,634	2,141,287	401,348
2009	-383,657	-510,550	126,893	1,578,187	1,069,475	508,712	1,961,844	1,580,025	381,819
2010	-499,379	-650,156	150,777	1,844,468	1,288,795	555,674	2,343,847	1,938,950	404,897
2011	-556,838	-744,139	187,301	2,112,825	1,495,853	616,973	2,669,663	2,239,991	429,672
2012	-534,656	-741,475	206,819	2,210,585	1,561,239	649,346	2,745,240	2,302,714	442,527

U.S. Census Bureau, Foreign Trade Division.

NOTE: (1) Data presented on a Balance of Payment (BOP) basis. Information on data sources and methodology are available at www.census.gov/foreign-trade/www/press.html.

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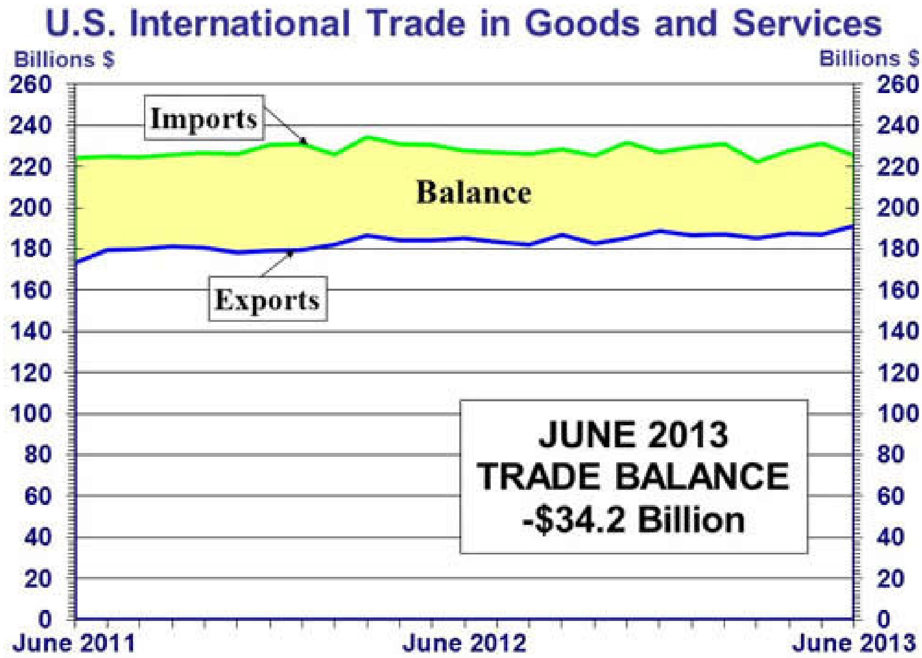
Exhibit 1 contd..



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