TAX SAVINGS (OR DEFERRAL) ON EXPORTED GOODS

If you export goods that you own (or take title to) and are produced, manufactured, grown or extracted in the United States, you may be able to significantly reduce the tax bill on ½ of the net income from such sales. This benefit can be enjoyed if you organize and utilize an "Interest Charge Domestic International Sales Corporation," commonly referred to as a "DISC."

A DISC is a statutorily created entity designed to promote exports. A DISC is a U.S. corporation whose shareholders elect that the corporation be treated as a DISC under the Internal Revenue Code. The DISC does not need to have employees or operating assets. However, it must be capitalized with at least $2,500.

The tax-savings is available because the DISC pays no U.S. income taxes so long as certain requirements are satisfied. However, the requirements for a DISC are relatively easy to meet. The tax-savings is a result of the exporter paying a commission to the DISC of up to ½ of its net income on export sales. The exporting entity deducts the commission thereby reducing its tax liability (or, if the exporter is a "flow-through" entity, the tax liability of the exporter's equity owners). Since the DISC pays no income taxes, the commission can be paid as a dividend which is currently subject to a maximum U.S. tax rate of 20%. (This article does not consider any impact of the "Net Investment Income Tax.")

Stated another way, the exporter deducts the commission and reduces its U.S. tax liability by, perhaps, 39.6%. The dividend from the DISC is reported as income, but is subject to, perhaps, a 20% tax rate. The net result is a reduction of taxes by almost 20 percentage points. **Simply stated, with a DISC, "ordinary" income is converted into income taxed at the lower long-term capital gains tax rate.** We refer to this use of a DISC as "tax rate arbitrage."

Tax Rate Arbitrage		
Net Export Income		$ 500,000
Allowed DISC Commission		$ 250,000
The Commission is:		
Deducted at US Tax Rate	39.6%	
Reported as Income, US Tax Rate	(20%)	
Tax Rate Reduction		19.6%
US Tax AVOIDED		**$ 49,000**

If the exporter is a flow-through entity (e.g., an entity taxed as a partnership or an S corporation), the DISC can be wholly owned by the exporter. All of the funds will remain within the two entities, unless the equity owner of the exporter decides otherwise. If the exporter is taxed as a C corporation, the DISC should be organized as a "sister corporation" with the DISC's shareholders being the same as the exporter's equity owners. If the funds are needed by the exporter, the equity owners could either loan or contribute the dividend proceeds to the exporter.

The benefits are available for goods that are exported only after the DISC is organized. Income from goods exported prior to the DISC's organization cannot be considered in determining the commission earned by the DISC. Therefore, if your facts indicate a DISC could be beneficial, you should act as soon as possible.

Another strategy of utilizing a DISC is to defer income taxes. The commission paid to the DISC can be loaned to the exporter (rather than being distributed as a dividend). The tax deferral is available on the commission earned on a maximum of $10 million of export gross receipts. So long as the funds are properly

documented as a loan, the funds do not create taxable income when transferred to the exporter. The most beneficial strategy will be determined by the cash flow requirements of the exporter and of the exporter's equity owners. If the deferral strategy is used, there may be short-term financing arrangements to be made at the end of each tax year to meet one of the requirements of a DISC.

Tax Deferral

	Without DISC	With DISC
Net Export Income	$ 500,000	$ 500,000
DISC Commission	-	(250,000)
Taxable Income	$ 500,000	$ 250,000
US Tax Rate	39.6%	39.6%
US Tax Liability	$ 198,000	$ 99,000
US Tax DEFERRED		**$ 99,000**

If the deferral strategy is used, or if all of the DISC's income is not distributed each year in the "arbitrage" strategy, there will be an interest charge imposed on any U.S. tax liability deferred through use of the DISC. This interest charge is imposed on the shareholders of the DISC (or the equity owners of the exporter, if the exporter is a flow-through entity). For 2015, the interest rate is approximately 0.24% (or .0024).

So long as the exporter can: identify/track the receipts from sales of goods for use outside the U.S., substantiate that the goods were delivered outside the U.S. and reasonably determine the costs associated with such sales, the exporter's day-to-day operations should not be impacted by the use of the DISC. All matters related to the DISC could be handled by the exporter's accounting staff and/or income tax preparers.

At least a preliminary commission determination must be made within 60 days after the end of the exporter's tax year. Such amount of commission must be settled within 60 days after the end of the DISC's tax year. The DISC could transfer such funds back to the exporter the same day or shortly thereafter. The final commission determination, and any needed transfer of funds, would need to be completed before the exporter and/or the DISC file tax returns for the subject year.

As with most tax benefits, requirements not mentioned in this article must be satisfied.

In summary, using a DISC could substantially decrease the tax liability on net income from export sales without substantially changing the day-to-day operations of the exporter. The U.S. tax rate could be reduced from 39.6% to 20% on such income. If your situation is described in this article, contact us to determine the possible benefit of using a DISC.

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