“A powerful tax break for exporters”

Margins are falling, markets are shrinking, and U.S. companies are finding it harder and harder to compete not only with their U.S. brethren, but with companies around the globe.

In fact, many U.S. firms face an uphill climb as they are being out-produced, outperformed and out-maneuvered by their foreign counterparts. The response of the small and middle-market company ranges from renewed international marketing efforts and advancements in efficiency and innovation, to layoffs and facility closings.

But there is another solution available: the TaxCode.

That’s right. Congress has a history of providing tax breaks to U.S. companies that export U.S. made products, and even certain services. These various incentives have come and gone throughout the years, but there is one left, and this tax strategy is powerful enough to increase a company’s after-tax margin on exports by 10 percent.

This option is called the Interest Charge Domestic International Sales Corporation, more commonly known as the “IC-DISC.” The IC-DISC traces its heritage as far back as 1971, but until 2003, it did little more than provide a tax-deferral opportunity. This benefit was well appreciated by the Fortune 1000, but it packed little punch for the small and middle markets. In 2003, the tide turned.

Today, the IC-DISC regime allows U.S. companies to set up separate domestic entities that act as commission agents for the company’s export sales. Once the IC-DISC is set up, the U.S. company can pay commission to the IC-DISC. These commissions can be as high as 50 percent of net export income or 4 percent of gross export receipts whichever is higher.

AN IMPORTANT INCENTIVE

But why is it a good idea to pay a commission to the IC-DISC? There are three reasons: First, the commission is fully deductible. Second, the IC-DISC pays no federal income tax. Third, the IC-DISC is, at heart, a Subchapter C corporation, meaning it distributed its income to its owners as a qualified dividend. The result is a permanent reduction in tax of 20 cents on every commission dollar (taking the difference between the top ordinary income rate and the qualified dividend rate).

There has been speculation that the benefits available through the IC-DISC may be short-lived. Many look for the Obama administration to eliminate the ability to take IC-DISC dividends as qualified dividends.

Others point to the imminent change in the ordinary income and qualified tax rates, and particularly the spread between the two, on which IC-DISC benefits depend. The current rates are set to expire Dec. 31, 2010. The administration's budget proposal would set qualified dividends at 20 percent, while raising the top ordinary income rat to 39.6 percent.

That is good news for U.S exporters, who face a struggling domestic economy and formidable international competition. But the clock is ticking. Unlike many incentives, which may be captured on old returns, IC-DISC benefits are only available for transactions occurring after the IC-DISC is set up.

HANDLE WITH CARE

On the surface, the rules governing the IC-DISC seems manageable. But all may not be what it seems. Jim Young, export practice leader at alliantgroup, mentions a company that was claiming a $120,000 tax benefit vie the IC-DISC. They had implemented the IC-

DISC themselves. Later, they brought in an outside consultant to review its structure and discovered that they should have been claiming $1.2 million in tax benefits quite a difference.

The IC-DISC, while offering extremely powerful benefits to companies, is littered with minefields and traps for the unwary. If not handled carefully, business may entirely miss out on the benefits or claim much less than they actually deserve.

It is particularly important that during these tough economic times accountants consult closely with their business clients to identify hose that may be eligible for the IC-DISC and to recommend strategies for implementation.