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Publication

Tax Incentive for Exporters

Could your company benefit from setting up a domestic international sales corporation?

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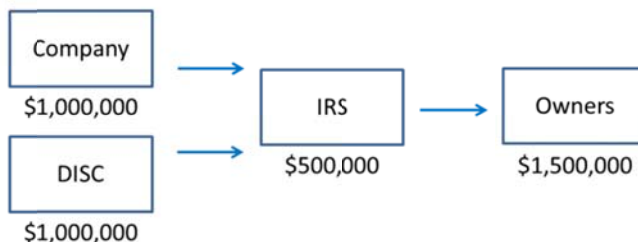
After all the partisan battling over “fiscal cliff” legislation, a little known tax break for domestic international sales corporations (DISCs) has been preserved, and offers a significant opportunity for businesses selling abroad. Whether your firm sells aerospace parts, software, or some other widgets, creating a DISC can move extra cash to the bottom line.

Let me start by asking you a question:

How much would you prefer to keep in your pocket?

Option A:

Option B:



Who wouldn’t want 15% more cash in their pocket at the end of the year? Especially if the savings is relatively easy to achieve, and does not require any material changes to the operations of the business. As illustrated below, by using a DISC structure, a business selling abroad may be able to achieve this level of savings on a recurring basis.

Although it may sound “too good to be true,” the DISC rules were established by Congress to help stimulate U.S. exports. It is intended that qualifying businesses will achieve this type of savings. For most businesses, the questions are: (1) does your business qualify; and (2) how much savings can you actually achieve?

Which Businesses May Benefit From a DISC Structure?

Qualifying businesses include manufacturers, software companies, and engineering or architectural firms with overseas projects.

Although a fairy broad section of businesses may qualify, the businesses that are most likely to obtain the greatest benefit from a DISC structure are closely-held businesses and foreign-owned businesses. (Although there are some exceptions, domestic public companies or their subsidiaries generally do not obtain the greatest benefit.)

It is relatively easy to determine if you should spend some time considering a DISC by answering two simple questions:

(1) Determine whether your business is likely to be considered a U.S. exporter by answering “yes” to <u>either</u> of the following questions:
   A. Does your business export any products?
   B. Does your business provide engineering or construction services for any projects outside of the U.S.?

(2) Assuming your business is a U.S. exporter, determine whether the owners are likely to benefit from a DISC by answering “yes” to <u>either</u> of the following questions:
   A. Is your business closely held?
   B. Is your business foreign-owned?

How Are DISC Benefits Provided?

A DISC is a separate corporation that exists solely to receive income from export sales on behalf of your existing business, generally by

receiving a commission from your existing business. The commission is tax deductible to your existing business. The DISC itself pays no taxes. However, when the DISC distributes funds to its owners, the owners are taxed – at qualified dividend rates.

Stated differently, a DISC effectively converts a portion of your ordinary business income into qualified dividend income.

The commission is charged on qualified export sales made by the operating business, which can include export sales and personal services relating to export sales, such as warranty, installation, and support.

The amount of the commission is established by Treasury Regulations, and can be quite favorable – typically the greater of 4% of gross receipts from export sales or 50% of taxable income from export sales.

Illustration: The following example illustrates how a DISC structure may reduce the federal effective tax rate from 35% to 25% on business income. While the actual savings will depend on the tax attributes of the business and its owners, this example illustrates the DISC principle based on a relatively simple set of facts.

Illustration of DISC Structure				
	Existing Structure	**DISC Structure**		
	S Corp/LLC	S Corp/LLC	DISC	Combined
Financial assumptions				
Gross receipts from export	$ 5,000,000	$ 5,000,000		
Net income (before DISC commission)	$ 2,000,000	$ 2,000,000		$ 2,000,000
Calculation of DISC commission				
A. 4% gross receipts method		$ 200,000		
B. 50% combined taxable income method		$ 1,000,000		
DISC commission (greater of A or B)	$ -	$ 1,000,000		
Taxable income (i.e., net income after DISC comm'n)	$ 2,000,000	$ 1,000,000	$ 1,000,000	$ 2,000,000
Taxes Paid				
Federal (35% assumed)	$ 700,000	$ 350,000	$ -	$ 350,000
Qualified dividend (15% assumed)	$ -	$ -	$ 150,000	$ 150,000
Cash After Tax	**$ 1,300,000**	**$ 650,000**	**$ 850,000**	**$ 1,500,000**
Effective Tax Rate (Federal only)	**35.00%**			**25.00%**
Savings Associated with DISC	**$ 200,000**			

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Conclusion

With this general background in mind, its time to consider whether your business may benefit from a DISC structure.

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