

## IC-DISCs After the ATRA of 2012

by Gary M. Harden

With the new year we have a new tax act and there is at least one new idea that should appeal broadly to businesses with any material foreign sales.

The American Taxpayer Relief Act of 2012 ended the automatic sunset provisions associated with the Bush Tax Cuts, and as a result provides a relative permanency to tax rate differentials now re-set in the tax code. By setting the rate on dividends at the long term cap gains rate, Congress made “permanent” the rate spread between top bracket individual ordinary income (39.6%) and dividends (20%) rates. Although the additional “Obamacare” taxes (3.8% on investment income and 0.9% on earned income) also weigh into the analysis, depending upon the brackets among related taxpayers, the permanency of this spread draws focus on tax planning with IC-DISCs. IC-DISCs are statutory, intended by Congress to motivate US companies to manufacture, produce and then export goods and related services to foreign countries using favorable tax rates as the cheese.

For participating manufacturers and producers last year, the tax rate savings was typically 20 percentage points, moving the effective bracket from 35% to 15%. Expiration of the Bush Tax Cuts by itself would have moved dividends back to the ordinary income rates where they were over a decade ago, eliminating the incentive altogether. The ATRA of 2012 as enacted leaves us with similar, and in some instances, better tax leverage opportunities, and the rate spread is not threatened by automatically expiring tax laws.

In addition to manufactured goods and produced farm products, a limited number of intangibles qualify. Among them, licenses of software (and other copyrights) and certain related services qualify. So high tax bracket owners of flow through entities that produce and license software for use outside the US, should evaluate this strategy if their related receipts are meaningful. Certain engineering and architectural designs, plans and drawings also can qualify.

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IC-DISC requires a minimal investment and minimal administrative distraction to effectuate. It requires the formation of a new domestic corporation and maintaining minimal capitalization. The cap requirement is only \$2,500. Everything else can be completed on paper. Qualifying foreign receipts are treated as sold through the IC-DISC on a commission basis. A commission agreement can be created with basic terms that would permit a business to merely identify the sales and other transfers they would want to cover, on a transaction basis as they happen in the future.

Although the IC-DISC must be established before the sale/license is completed, commissions are all statutory and can be calculated and paid later in the year with the assistance of the company's accountant. The IC-DISC does not pay tax on these commissions. It is tax exempt. A very small interest charge must be paid to IRS on commissions that are received and not distributed. There is an opportunity to defer income to later years, so the owners of an IC-DISC can time their recognition of income from year to year depending upon changing circumstances. When the owners distribute the earnings to the IC-DISC shareholders, or want to treat the earnings as having been distributed, the shareholders pay tax at the lower dividends rate. Owners of IC-DISC can be taxpayers at lower tax brackets than owners of the operating entity, and so the ultimate tax on income from these sales could be reduced to a dividend rate of 15% or even 0%.

Of course there are technical rules to apply, tax returns to file, etc. It is intended to be within the reach of closely held and entrepreneurial businesses who want to do tax planning and have advisors to help them. I welcome the opportunity to discuss IC-DISC and to see if one may work for you.

*If you have any questions about this or any other tax issue, please contact Gary M. Harden at 419-241-6000 or visit our website at [www.eastmansmith.com](http://www.eastmansmith.com).*

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