DOMESTIC INTERNATIONAL SALES CORPORATIONS

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The DISC can amount to a tax subsidy for an engineering or architectural firm's foreign construction projects.

As the U.S. economy continues to find its way out of the recession, many engineering and architectural firms are looking outside the United States for projects. Under the current U.S. income tax scheme, these firms may be eligible for a very favorable tax subsidy for construction projections located abroad. As you know, the current U.S. income tax environment is:

- The maximum corporate and individual ordinary income tax rate is 35% and
- Qualified dividend income is taxed at 15%

This subsidy creates an ordinary income tax deduction (35%) with a corresponding income amount taxable as a qualified dividend (15%); creating a 20% income tax rate arbitrage.

> ***Example:*** *An engineering firm designs a road located in a foreign country. The contract price is $1,000,000 and the engineering costs are $600,000. The firm is taxed as an S Corporation. The firm pays a $200,000 commission to a Domestic International Sales Corporation (DISC), reducing the former's taxable income by such an amount. The DISC does not pay tax on the commission it just earned. The DISC's owners (typically the firm's owners) receive a $200,000 dividend from the DISC and pay tax at the qualified dividend rate. There is an immediate increased cash flow of up to 20% of $200,000, or $40,000.*

There are many variations of a Domestic International Sales Corporation. This article addresses a simple format to illustrate the concept. The term “engineering firm” will be used to include an architectural firm, unless otherwise noted.

Definition of the DISC

A DISC is a U.S. corporation that makes an election [1] to be treated for U.S. income tax purposes as a DISC. This corporation's sole purpose is to receive a commission from the engineering firm based on the latter's international activity. As such, 95% or more of the DISC's gross receipts must be from “qualified export receipts.” [2] Furthermore, the corporation can only have one class of stock with a stated or par value being at least $2,500 on each day of the taxable year. [3] As a practical matter, a new corporation should be established to operate as a DISC; and the only activity should be receiving commission income and paying dividends.

DISC ownership

Most of the time, the owner(s) of the engineering firm will be the DISC shareholder(s).An owner could also be a member of the management team that the owner wants to reward. Others have used the DISC as an estate planning tool to shift assets to another generation.

DISC election rules; when effective

As mentioned above, the corporation must make a DISC election. Only engineering services rendered after the DISC election is made will qualify for DISC treatment. The two time frames in which the election must be made are:

- For the first taxable year, within 90 days after the beginning of such taxable year;
- During the 90-day period immediately preceding the first day of such taxable year. [4]

For example, assume the DISC makes the election effective June 1, 2009. Only the services rendered after that date for foreign construction projects will be eligible for a DISC commission.

"Qualified export receipts"

Qualified export receipts are gross receipts from engineering services or architectural services furnished by a DISC for a construction project located, or proposed for location, outside the United States. The actual engineering or architectural service may be performed within or outside the United States. [5]

"Engineering services" is broadly defined to include any professional services requiring engineering education, training, and experience. The scope of the services includes consultation, investigation, evaluation, planning, design, or responsible supervision of construction for the purpose of assuring compliance with plans, specifications, and design. [6] Similarly, architectural services include consultation, planning, aesthetic and structural design, drawings and specifications, responsible supervision of construction or erection. [7]

Engineering and architectural services include feasibility studies for a proposed construction project whether or not such project is ultimately initiated; but they do not include activities or programs designed to enable business, commerce, industrial establishments, and governmental organizations to acquire or use scientific, architectural, or engineering information. [8]

A "construction project" includes the erection, expansion, or repair (but not including minor remodeling or minor repairs) of new or existing buildings or other physical facilities including, for example, roads, dams, canals, bridges, tunnels, railroad tracks, and pipelines. The term also includes site grading and improvement and installation of equipment necessary for the construction. [9]

Effect on firm's business operations

The bottom line is that the DISC does not affect the firm's day-to-day dealings with its clients; they do not even know that the DISC exists. The firm is still providing the services and billing the client on its letterhead.

The definition of qualified export receipts includes a phrase "services furnished by a DISC." What occurs is the firm enters into a commission arrangement with the DISC, whereby the former performs the services and the DISC acts as the "commission agent for such services." [10] Again, the client does not deal with DISC.

Determination of commission calculation

As mentioned in the introduction, there are two legs to the DISC tax rate arbitrage: creating an ordinary commission expense and generating a dividend payment. The DISC commission can be calculated under two objective safe harbor methods; or can be calculated under the subjective transfer pricing rules. [11]

The first safe harbor commission rate is 4% of the engineering firm's qualified export receipts, plus 10% of the export promotion expenses. The second safe harbor calculation is 50 percent of the firm's taxable income attributable to the qualified export receipts, plus 10 percent of the export promotion expenses. The second safe harbor requires that the firm allocate its direct and indirect costs between jobs that qualify for the DISC commission and those that do not.

For purposes of this section, the term "export promotion expenses" means those expenses incurred to advance the distribution or sale of export property for use, consumption, or distribution outside of the United States. [12]

> ***Example:*** *An engineering firm designs a road in a foreign country. The contract price is $1,000,000; the direct costs are $450,000 and the indirect costs are $150,000. The DISC commission is the greater of $40,000 (4% of $1,000,000); or $200,000 (50% of $400,000)*

The transaction

During the year, the engineering firm provides services that qualify for the DISC commission. At year's end, the engineering firm decides what qualifying services it wants to include in the commission formula. The firm accrues or pays the calculated commission to the DISC. The DISC then distributes the funds as a dividend to the DISC shareholders. For the past few years, it has been our recommendation to clients to pay the commission and the dividend before year end; the reason being the uncertainty of tax legislation that may increase the tax rate on qualifying dividends. If possible, the better tax strategy may be to accrue the commission expense in year one and pay the dividend in year two.

Using the above illustration, the engineering firm would accrue or pay the $200,000 DISC commission (sheltering up to 35 cents per dollar). The DISC would turn around and pay a dividend to the owners (taxed at 15 cents per dollar). If one is certain that the dividend rate will not increase in a subsequent year, suggest delaying paying the dividend until the subsequent year.

Tax compliance

The DISC should be a newly incorporated entity. After obtaining a tax identification number, the DISC election is made on IRS Form 4876A. The DISC activity is filed on the annual tax return Form 1120DISC. The DISC owners receive a Schedule K-1 reflecting their dividend.

Conclusion

Once a firm commits to the business decision to work on projects located outside the United States, the feasibility of establishing a DISC should be a matter of course. No one knows the timing and magnitude of income tax rate changes; but if the spread between tax rates on ordinary income and dividend income remain, the DISC is a viable structure. Even if the firm can use the DISC for one or two years, the cash flow savings are permanent.

IRC 992(a)(1)(D)

IRC 992(a)(1)(A)

IRC 992(a)(1)(C)

Regs. 1.992-2(a)(2)

IRC 993(a)(1)(G); Regs. 1.993-1(h)(1)

Regs. 1.993-1(h)(5)

Regs. 1.993-1(h)(6)

Regs. 1.993-1(h)(2), (3)

Regs. 1.993-1(h)(8)

Regs. 1.993-1(h)(7)

IRC 994

IRC 994(c)

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