

# ALL EYES ON THE I.C.-D.I.S.C. PART ONE: THE EXPORT GIFT THAT KEEPS ON GIVING

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## Tags

Export Receivables

I.C.-D.I.S.C.

International Sales

Producer's Loans

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## INTRODUCTION

Regardless of their political affiliations, presidential administrations and members of Congress share the goal of maintaining U.S. competitiveness on the global market. We often hear statements directed toward strengthening the U.S. manufacturing sector and bringing production activity back to the U.S. These words would be futile without implementing initiatives favoring U.S. business interests.

Providing tax incentives is one mechanism in which the government can act upon these objectives.<sup>1</sup> Well-known examples include:

- **The F.D.I.I. Deduction:** Corporations may claim deductions under the Foreign Derived Intangible Income rules of §250 of the Internal Revenue Code of 1986 as currently in effect (the “Code”). F.D.I.I. derived by a U.S. corporation is eligible for a deduction of 37.5% for tax years beginning before 2026 and 21.875% thereafter. At the U.S. corporate income tax rate of 21%, the deductions have the effect of reducing the tax rate on F.D.I.I. to 13.125% for tax years beginning before 2026 and 16.406% for tax years beginning after 2025.
- **The Q.B.I. Deduction:** For partnerships and L.L.C.’s owned by individuals, the Qualified Business Income (“Q.B.I.”) deduction of Code §199A provides a deduction for partners and members of partnership or L.L.C. employing many employees or having significant investment in capital assets.<sup>2</sup> For partners or members of L.L.C.’s that do not fit the profile, caps are placed on the benefit.

An often-overlooked incentive is the Interest Charge Domestic International Sales Corporation (“I.C.-D.I.S.C.”) regime, a long-lived descendent of the (i) the original Domestic International Sales Corporation (“D.I.S.C.”) regime, in effect between 1972

<sup>1</sup> The extent to which a tax incentive to promote exports may violate trade agreements is beyond the scope of this article. For articles on illegal tax subsidiaries see Beate Erwin and Christine Long, “E.U. State Aid – the Saga Continues,” *Insights* Vol. 3 No. 6 (June 2016); Beate Erwin and Kenneth Lobo, “Treasury Attacks European Commission on State Aid – What Next?,” *Insights* Vol 3 No. 8 (September 2016); and Fanny Karaman, Stanley C. Ruchelman and Astrid Champion, “European State Aid and W.T.O. Subsidies,” *Insights* Vol. 3 No. 9 (October 2016). For the dispute between European jurisdictions and the U.S. over the D.I.S.C. rules, see Block, 6360 T.M., *Export Tax Incentives*, Section I, Prior Export Tax Incentives Under the Code.

<sup>2</sup> See Fanny Karaman and Nina Krauthamer, “The Devil in the Detail: Choosing a U.S. Business structure Post-Tax Reform,” *Insights* Vol 6 No. 6 (June 2019) and Fanny Karaman and Nina Krauthamer, “Qualified Business Income – are You Eligible for a 20% Deduction?,” *Insights* Vol. 5 No. 2 (October 2018).

and 1984, (ii) the Foreign Sales Corporations (“F.S.C.”),<sup>3</sup> in effect between 1985 and 2000, a successor of the D.I.S.C., (iii) the Extraterritorial Income (“E.T.I.”) regime was adopted in 2000 and remained in effect until its repeal in 2004, which provided an exclusion for the portion of gross income consisting of extraterritorial income. The common thread of all the foregoing predecessors of the was their complexity. The lone exception was the I.C.-D.I.S.C., an attractive tax planning tool for smaller companies without fully staffed tax departments. For privately held companies operating as an L.L.C. treated as a pass-through entity, the goal is not the deferral of tax over an indefinite period of time. Rather, the benefit is an immediate and permanent tax rate reduction.

This article is the first of a two-part series. Part I highlights the technical aspects of the I.C.-D.I.S.C. and how certain taxpayers can benefit when structuring export activities. Part II will identify issues that frequently arise during I.R.S. examinations.

## HISTORICAL CONTEXT

As originally enacted in 1971, a D.I.S.C. was simply a domestic corporation that made an election to be treated as a D.I.S.C. If it met all the requirements under the law, the D.I.S.C. was exempt from U.S. corporate income tax. Its function, which could take place “only on paper” accompanied by journal entries, was to serve as a buy-sell distributor or a commission sales agent. Either way, the U.S. exporter reduced its income, while the D.I.S.C. paid no U.S. tax as its paper profits grew.

At that point, the goal of the U.S. exporter was to access the proceeds of profits building up in the D.I.S.C. in order to use the cash in the export business, without triggering a loss of deferral. Methods were available – the D.I.S.C. could finance export promotion expenses, purchase export receivables from the related exporter, or make a producer’s loan to finance the production of export property. Each method had its own set of rules designed to provide the appearance of substance, when none existed but for the paperwork. More importantly, as profits remained in the D.I.S.C. and sales remained relatively flat, it became harder to utilize the resulting proceeds in ways that met rules established by the I.R.S. Failing to meet those rules resulted in loss of D.I.S.C. status and recapture of the D.I.S.C. deferred tax over a period of time.

In 1985 when the F.S.C. regime was adopted in lieu of the D.I.S.C. regime, one limited category of D.I.S.C.’s was allowed to continue in existence. Under the 1985 regime, Small D.I.S.C.’s that agreed to pay an interest charge on the amount of tax deferred were allowed to continue on in the form of an I.C.-D.I.S.C. To be categorized as a Small D.I.S.C., the amount of D.I.S.C. profits that could be deferred was capped at \$10 million. D.I.S.C. export profits exceeding that amount were deemed to be distributed immediately and were not eligible for deferral. The interest charge on deferred profits was imposed at a rate that was announced annually by the I.R.S.

As explained in the next portion of this article, deferral of tax is not the goal of the L.L.C. exporting from the U.S. The benefit is the permanent rate reduction for the portion of export profits allocated to the I.C.-D.I.S.C. under a special set of transfer pricing rules.

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<sup>3</sup> Code §922 through 927 in effect between 1984 and 2000).

## TAX BENEFIT OF AN I.C.-D.I.S.C.

The export commission payment paid by the U.S. exporter or the amount by which its export sales margin is reduced by the sale to the I.C.-D.I.S.C. generates an immediate and permanent tax saving for the partners or members of the business. To illustrate, the maximum tax rate for ordinary income realized by individuals is 37%. In addition, self-employed individuals must pay 12.4% self-employment tax on self-employment income up to a ceiling that increases each year with inflation. In 2023, the ceiling is \$160,200 of self-employment income. Finally, self-employed individuals must pay a 2.9% Medicare tax. Because there is no cap on the tax base for the Medicare tax, the maximum effective tax rate for the partners or members of the business is 39.9%, disregarding self-employment tax.

*“The amount of net profits generated by the I.C.-D.I.S.C. under special transfer pricing rules applicable to I.C.-D.I.S.C.’s and exporting companies are not subject to tax at the I.C.-D.I.S.C. level.”*

The amount of net profits generated by the I.C.-D.I.S.C. under special transfer pricing rules applicable to I.C.-D.I.S.C.’s and exporting companies are not subject to tax at the I.C.-D.I.S.C. level. When the I.C.-D.I.S.C. distributes its net profits to the shareholder group – here comprised of members of the related business – the shareholder will be treated as having received a qualified dividend taxed at a maximum rate of 20%. To that tax, a 3.8% add-on for net investment income tax (“N.I.I.T.”) likely will apply. Assuming that each partner or member generates self-employment income from the business and disregarding the 12.4% self-employment tax on the first \$160,200, each dollar of export commission paid to the I.C.-D.I.S.C. or margin on exports allocated to the I.C.-D.I.S.C. is taxed at the lower combined rate of 23.8% rather than 39.9%. This creates a net effective tax reduction of 16.1 percentage points, yielding a 40% reduction of Federal income tax. For most entrepreneurs, a 40% tax reduction for doing nothing would seem to be more attractive than a deferral opportunity that is constantly subject to risk of early recapture.

## TECHNICAL ASPECTS OF THE I.C.-D.I.S.C.

The technical details of operating an I.C.-D.I.S.C. are as follows. As mentioned above, they must be meticulously followed in order for the members of an L.L.C. operating an export business to benefit from the tax rate reduction.

### **Requirements**

An entity must meet the following conditions to qualify as an I.C.-D.I.S.C.:

- It must be incorporated under the law of one of the states of the United States.<sup>4</sup>
- At least 95% of the gross receipts during the taxable year must qualify as export receipts.<sup>5</sup>
  - Qualified export receipts consist primarily of revenues from the sale of export property.<sup>6</sup>
  - Export property must be property produced in the U.S. by a person other than the I.C.-D.I.S.C. for sale outside the U.S.

<sup>4</sup> Code §992(a)(1).

<sup>5</sup> Code §992(a)(1)(A).

<sup>6</sup> Code §993(a)(1).

- Not more than 50% of the value of the property may be attributed to articles imported into the U.S.<sup>7</sup>
- Export property does not include intellectual property or property leased to another member of a control group in which it belongs.<sup>8</sup>
- At least 95% of the total adjusted bases maintained by the I.C.-D.I.S.C. in its assets at the close of the taxable year must consist of qualified export assets. Qualified export assets generally include
  - export property,
  - assets used in connection with the sale of export property,
  - accounts receivable from sale of export property,
  - working capital,
  - producer's loans, and
  - other related assets.<sup>9</sup>
- It must have only one class of shares, with a stated value of at least \$2,500 on each day during the taxable year.<sup>10</sup>
- It must make an effective election to be treated as a D.I.S.C.<sup>11</sup>
  - An election shall be made during the 90-day period before the beginning of the tax year with the consent of all shareholders.<sup>12</sup>
  - If the entity fails to make a timely election, it can request an extension to file with the I.R.S. by demonstrating it acted reasonably and in good faith, and the grant of relief will not prejudice the government's interest.<sup>13</sup>

Failure of an entity to qualify as an I.C.-D.I.S.C. will subject the commission payment to double tax: a corporate tax when received by the I.C.-D.I.S.C. and second level of tax when distributed.

The I.C.-D.I.S.C. is not required to follow the arm's length principle under Code §482.<sup>14</sup> If Code §482 were applicable, all profits of the I.C.-D.I.S.C. would be reallocated to the exporting company.

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<sup>7</sup> Code §993(c)(1).

<sup>8</sup> Code §993(c)(2).

<sup>9</sup> Code §993(b).

<sup>10</sup> Code §992(a)(1)(C).

<sup>11</sup> Code §992(a)(1)(D).

<sup>12</sup> Code §992(b)(1).

<sup>13</sup> Treas. Reg. §301.9100-3(a).

<sup>14</sup> Code §994(a).

The I.C.-D.I.S.C. does not need employees, equipment, or office space. It need not engage in any specific activity. In reality, the company is not fixed in reality. It exists merely on paper. And yes, the Code permits this.

### **Structuring**

Any type of entity or individual may hold ownership interests in an I.C.-D.I.S.C. A pass-through entity such as an L.L.C., may hold the ownership interest in an I.C.-D.I.S.C., which is a domestic corporation for which an election is made. The shareholders of the I.C.-D.I.S.C. may be the exporting company or L.L.C. or the exporter's owners. If the I.C.-D.I.S.C. has many individual owners, ownership interests could be held in a partnership or second L.L.C.

### **Classifications of I.C.-D.I.S.C.'s**

There are two types of I.C.-D.I.S.C.'s – a buy-sell I.C.-D.I.S.C. and a commission I.C.-D.I.S.C. A buy-sell I.C.-D.I.S.C. purchases export property from the exporting company and is required to take title. It then serves as principal in a sale or lease of the export property to customers outside the U.S.

A commission I.C.-D.I.S.C. is used more frequently since it can achieve the same tax benefits without taking title to the property and without being involved in the sale to customers overseas. The I.C.-D.I.S.C. is treated as an agent even though the exporting company conducts all the activity of selling the products outside of the U.S., acting pursuant to an agency agreement that must be in place and honored by the exporting company and the I.C.-D.I.S.C. The exporting company pays the I.C.-D.I.S.C. a commission as compensation for its services. Again, arm's length transfer pricing rules are not applicable if certain statutory transfer pricing rules are elected. This is discussed below.

The I.C.-D.I.S.C. then distributes the cash to its owners. If the exporting company requires cash and is the owner of the I.C.-D.I.S.C., the distribution will be paid directly to the company. If the I.C.-D.I.S.C. is owned by the same persons that own the exporting company, the distribution will be paid to them after which the proceeds will be contributed to the company. The latter ownership works better if each member in the ownership group owns both companies in the same percentage.

Since the commission I.C.-D.I.S.C. is most commonly used, the following section analyzes the effects of using such structure.

### **Operation and Tax Effects of a Commission I.C.-D.I.S.C.**

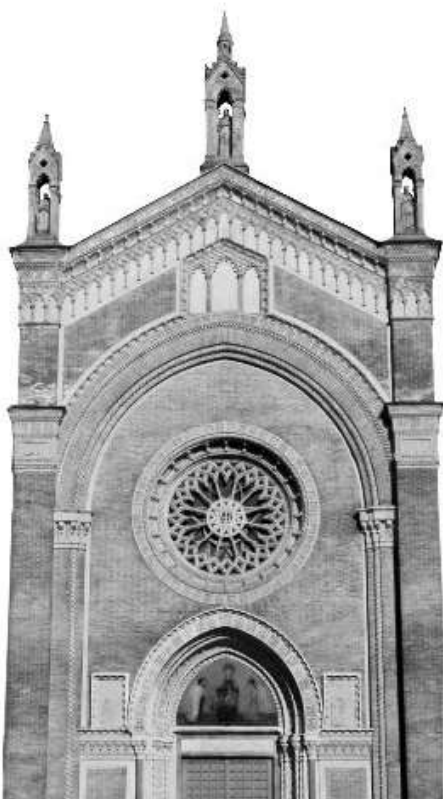
#### **Commission Payment**

The exporting company pays a commission to the I.C.-D.I.S.C. based on foreign sales of export property. The deduction is disallowed to the extent it causes the export company to report a loss for the taxable year.<sup>15</sup> Hence, the commission agreement should contain a no-loss cap on commission payments.

The commission is computed using one of three methods:

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<sup>15</sup> Code §1.994-1(e)(1).



- The 4% of export gross receipts method
- The 50% of combined taxable income
- The arm's length taxable income method determined under Code §482, which is almost never used<sup>16</sup>

The method can be selected on a transaction-by-transaction basis.<sup>17</sup> In general, a taxpayer selects the method which produces the highest commission on a given transaction, thereby generating the highest tax benefit. Of the three methods available, the 4% of export gross profits method is the easiest to compute and the 50% method is used for exports of higher net margin items.

Under the 4% method, the commission is 4% of the qualified export receipts plus 10% of the export promotion expenses ("E.P.E.") attributable to such receipts.<sup>18</sup> E.P.E. are expenses incurred to advance the sale of export property for use outside the U.S.<sup>19</sup> In general, only expenses related to the I.C.-D.I.S.C.'s employees or property qualify as E.P.E. In most cases, the I.C.-D.I.S.C. will have neither resulting in zero E.P.E.

Under the 50% method, the commission is 50% of the combined taxable income of the I.C.-D.I.S.C. and the export company attributable to qualified export receipts plus 10% of the E.P.E. attributable to such receipts.<sup>20</sup>

### *I.C.-D.I.S.C. Distributions*

A shareholder of an I.C.-D.I.S.C. can receive actual dividends or constructive dividends. An actual dividend occurs when the I.C.-D.I.S.C. distributes cash or other property to the shareholder. A constructive dividend is an amount deemed distributed to the shareholder for which deferral is not permitted. Constructive dividends include interest on a producer's loan,<sup>21</sup> gains from certain appreciated assets transferred to an I.C.-D.I.S.C.,<sup>22</sup> and taxable income attributable to qualified export receipts that exceed \$10.0 million.<sup>23</sup> A constructive dividend is treated as a qualified dividend that benefits from long-term capital gains tax rates.<sup>24</sup> If a shareholder is a taxable C-corporation, the deemed distribution also includes 1/17th of the I.C.-D.I.S.C.'s taxable income that is not otherwise deemed distributed under other provisions.<sup>25</sup>

For more sophisticated companies that can manage the I.C.-D.I.S.C. process with accuracy throughout the year, the I.C.-D.I.S.C. would funnel cash proceeds to the exporting company in ways that will not put the I.C.-D.I.S.C. election at risk, commissions are paid near the end of the fiscal year, and the corresponding distribution

<sup>16</sup> Code §994(a).

<sup>17</sup> Treas. Reg. §1.994-1(b).

<sup>18</sup> Code §994(a)(1).

<sup>19</sup> Treas. Reg. §1.994-1(f).

<sup>20</sup> Code §994(a)(2).

<sup>21</sup> Code §995(b)(1)(A).

<sup>22</sup> Code §995(b)(1)(B).

<sup>23</sup> Code §995(b)(1)(E).

<sup>24</sup> Code §995(b)(1), initial sentence; Code §1(h)(11)(B)(i)(I).

<sup>25</sup> Code §995(b)(1)(F)(i).

follows soon after, usually within a day. For less sophisticated companies, the funds generated from the commission can be distributed to the shareholders immediately and rechanneled to the exporting company.

### Interest Charge

The I.C.-D.I.S.C. may defer distributing taxable income attributable to qualified export receipts but not more than \$10 million. However, the shareholder will be charged interest in connection with the deferred amount.<sup>26</sup> The interest charge is imposed on a hypothetical tax liability using ordinary tax rates as opposed to the qualified dividend rate.<sup>27</sup> The interest rate is set at the one-year Treasury bill rate.<sup>28</sup>

For the exporting company that is privately held, deferral is usually not the major goal in setting up an I.C.-D.I.S.C. Absolute tax reduction is likely the play.

## ADDITIONAL BENEFITS

For privately held companies that are more interested in deferring tax on up to \$10.0 million of export gross receipts, methods are available to channel funds back to the exporting company without putting the I.C.-D.I.S.C. election at risk.

### Producer's Loans

As noted, the interest charge on deferred distributions is equal to the one-year Treasury bill rate, which is a relatively low rate. Prior to the interest-charge amendment in the 1980's, D.I.S.C.'s would defer distributions and extend a producer's loan" to the exporting company. If properly structured, producer's loans allow the exporting company to invest earnings in export operations without triggering recognition of the deferred tax liability for the shareholder of the D.I.S.C. This can still be done with an I.C.-D.I.S.C., but subject to the interest charge. The exporting company deducts the interest expense, and the receipt of interest by the I.C.-D.I.S.C. is not subject to tax at the level of the I.C.-D.I.S.C. The interest income gives rise to a constructive dividend from the I.C.-D.I.S.C. that is included in the shareholder's taxable income for that tax year.<sup>29</sup> In substance, the producer's loan is a source of cheap credit for the exporter. For an export company operating as an L.L.C. owned by individuals, the interest expense on the producer's loan reduces ordinary income of the business and increases qualified dividend income for the I.C.-D.I.S.C. shareholders.

A loan must meet several criteria in order to be treated as a producer's loan:

- When added to the unpaid balance of all other producer's loans, the new loan does not cause the outstanding balance of all existing loans to exceed the accumulated I.C.-D.I.S.C. income as of the beginning of the month in which the loan is made.
- The loan is evidenced by a note with a maturity date of not more than five years from the date of the loan.

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<sup>26</sup> Code §995(f).

<sup>27</sup> Code §995(f)(2)(A)(ii).

<sup>28</sup> Code §995(f)(1)(B).

<sup>29</sup> Code §995(b)(1)(A)).

- The loan is made to a person engaged in a business involving manufacturing, production, growing, or extraction of export property in the U.S.
- The loan is designated as a producer's loan.<sup>30</sup>

The interest rate must comply with arm's length principles. The loan can be made to any party, not just the exporting company, provided all tests listed above are met. Loans to other parties effectively allow an I.C.-D.I.S.C. to meet the asset qualification test when its qualified export income is in decline from year to year.

### **Accounts Receivable Factoring**

Accounts receivable factoring is another tax saving consideration for those exporting companies favoring a path towards deferral. Accounts receivable factoring allows a company to sell its export accounts receivable to another party at a discount in exchange for immediate cash.

An exporting company can sell its account receivables at an arm's length discount to the I.C.-D.I.S.C. and deduct the loss. The income earned by the I.C.-D.I.S.C. is recognized as qualified interest income and is tax-exempt.<sup>31</sup> The distributions to shareholders are qualified dividends. This arrangement similarly allows the export company to reduce income taxed at ordinary tax rates in exchange for the receipt of a qualified dividend taxed at favorable long-term capital gains tax rates.

### **Roth I.R.A. Contributions**

Tax exempt entities such as Roth I.R.A.'s may hold shares in an I.C.-D.I.S.C., although, any distribution will be treated as unrelated trade or business income taxed at ordinary income rates.<sup>32</sup> A Roth I.R.A is an individual retirement account to which contributions are made from after-tax income. However, investment income and gains grow on a tax-free basis. Distributions from a Roth I.R.A. account that are made after reaching retirement age are also tax-free. The Code places certain restrictions on Roth I.R.A. contributions.<sup>33</sup> However, the contribution limits do not apply to distributions made from an I.C.-D.I.S.C. Thus, the I.C.-D.I.S.C. can distribute its earnings, subject to tax at ordinary tax rates, to the shareholder that is a Roth I.R.A. and grow those earnings tax-free.

The I.R.S. challenged the use of these arrangements under the substance-over-form doctrine, but Federal circuit courts of appeals have ruled in favor taxpayers.<sup>34</sup>



<sup>30</sup> Code §993(d)(1).

<sup>31</sup> See Rev. Rul. 75-430 (accounts receivable resulting from the sale of export property are qualified export assets and the discount is a qualified export receipt).

<sup>32</sup> Code §995(g).

<sup>33</sup> Code §408A(c)(2) and (3). For 2023, the maximum contribution limit is \$6,500 annually, or \$7,500 age 50 or older. Also, for 2023, the taxpayer's modified adjusted gross income must be under \$153,000 for single filers and \$228,000 if married filing jointly.

<sup>34</sup> See *Summa Holdings, Inc. v. Commr.*, 848 F.3d 779 (6th Cir. 2017) (utilizing the I.C.-D.I.S.C. to make payments to the Roth I.R.A.'s was valid under the I.R.C.); *Benenson v. Commr.*, 887 F.3d 511 (1st Cir. 2018) (since they payments were valid, the shareholders were not liable for excise taxes for excess contributions to the Roth I.R.A.'s); and *Benenson Jr. v. Commr.*, 910 F.3d 690 (2d Cir. 2018) (since they payments were valid, the shareholders were not liable for tax deficiencies).



The family of cases involved an export company (“ExportCo”) owned by a husband, wife, and a family trust, of which the couple’s two children were the beneficiaries. Two Roth I.R.A.’s were established for the children. The Roth I.R.A.’s purchased shares in ExportCo’s I.C.-D.I.S.C., and then transferred the shares to a HoldCo. ExportCo paid commission to the I.C.-D.I.S.C, which distributed the commission to the HoldCo. HoldCo paid tax on the dividends and distributed the balance to its shareholders, the two Roth I.R.A.’s. The tax benefit was not tax rate arbitrage since Code §995(g) negates the possibility. Instead, the arrangement generated income for the Roth I.R.A.’s that simply were not taxed.

The I.R.S. applied the substance-over-form doctrine and asserted that (i) the payments from ExportCo to the I.C.-D.I.S.C. were not commissions but dividend distributions to ExportCo shareholders, and (ii) the distributions from HoldCo to the Roth I.R.A.’s were not dividends but contributions to the Roth I.R.A.’s in excess of the contribution limits.

In each of the three cases, the U.S. Tax Court ruled in favor of the I.R.S. finding it appropriate to recharacterize the transaction under the substance-over-form doctrine. However, the three U.S. Federal Circuit Courts reversed and held for the taxpayers in three separate decisions. Each reasoned that the Roth I.R.A. and D.I.S.C. provisions are designed to allow for favorable tax treatment. The substance-over-form doctrine does not give the I.R.S. a warrant to search through the Code and correct whatever oversights and mishaps Congress happens to make. Since the transactions did not violate the plain intent of the relevant statutes, the doctrine did not apply.

*“The substance-over-form doctrine does not give the I.R.S. a warrant to search through the Code and correct whatever oversights and mishaps Congress happens to make.”*

## INTERPLAY WITH F.D.I.I.

In 2018, the T.C.J.A. introduced an additional export friendly provision – a deduction for F.D.I.I. F.D.I.I. is the portion of a U.S. corporation’s intangible income derived from serving foreign markets determined under a formulaic method. In general, Code §250 allows a U.S. corporation to deduct 37.5% of its F.D.I.I. (21.87% for tax years beginning after December 31, 2025) resulting in an effective tax rate of 13.125% on eligible income. The F.D.I.I. deduction is not available to individuals operating an export business through a partnership or L.L.C.

Where the export company is a C-corporation, it could potentially claim the F.D.I.I. deduction in addition to the I.C.-D.I.S.C. commission deduction. While the two regimes have varying scopes of applicable transactions, many transactions qualify under both sets of rules. In a situation where a transaction qualifies for I.C.-D.I.S.C. benefits and the F.D.I.I. deduction, the Code does not prohibit the use of both regimes. However, in so doing, there is a circular effect in which both sets of provisions impact the other. The I.C.-D.I.S.C. commission reduces the F.D.I.I. deduction, and the F.D.I.I. deduction reduces the net profits of the I.C.-D.I.S.C.<sup>35</sup> While the maximum benefit under either regime is reduced, the net benefit could be increased by using both. The taxpayer may also be better off using one set of rules and not the other for a given transaction. Tax modeling should be adopted on a case-by-case basis to determine the respective benefits.

<sup>35</sup>

See Code §250(b)(3)(A)(ii) and Treas. Reg. §1.994-1(c)(6)(iii), respectively.

## FOREIGN SHAREHOLDERS

In the case of a foreign shareholder, Code §996(g) treats distributions from an I.C.-D.I.S.C. as income that is effectively connected with the conduct of a trade or business through a U.S. permanent establishment. Many foreign shareholders have contended that a deemed permanent establishment provided under U.S. law cannot override the definition of an actual permanent establishment provided in an income tax treaty that is in force and effect between the U.S. and a foreign country. If the treaty takes precedence, and no permanent establishment exists, the withholding tax rate for dividends should be applicable rather than the U.S. tax rate on effectively connected income and possibly branch profits tax

In November 2022, the Office of Chief Counsel issued advice to I.R.S. personnel regarding this matter.<sup>36</sup> According to the advice, Code §996(g) requires foreign shareholders to treat I.C.-D.I.S.C. distributions as income items that are deemed to be attributable to a permanent establishment. According to the advice, U.S. tax treaties should be applied in a manner that is consistent with the Code wherever possible. Taxpayer arguments that focus on the later-in-time rule – if there is a conflict between domestic law and a treaty, the one that is later in time controls – codified in Code §7852(d) does not apply. The I.R.S. also indicated this interpretation is based on congressional intent.<sup>37</sup>

While the advice is not binding precedent on a court, it signals foreign shareholders of an I.C.-D.I.S.C. will face challenges by the I.R.S. if contending that I.C.-D.I.S.C. distributions do not give rise to effectively connected income and business profits attributable to the deemed existence of a permanent establishment. More importantly, the likelihood of success is low in light of deference that is ordinarily given to legislative history.

## CONCLUSION

The I.C.-D.I.S.C. is an underrated tool that can provide substantial tax benefits to export companies operating as L.L.C.'s that are owned by individuals. It is a company having operations only on paper that has been designed intentionally to generate tax benefits. In other words, it is an anomaly in today's tax world that is hyper-focused on substance. Utilization is relatively simple, but the requirements must be strictly followed to avoid undesired tax consequences. The compliance challenge will be addressed in Part II of this series.

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<sup>36</sup> AM 2022-005 - Section 996 - Rules for Allocation in the Case of Distributions and Losses.

<sup>37</sup> H.R. Rep. 98-861, at 977 (1984) (“The provision that clarifies present law to make it clear that a resident of a treaty partner country cannot avoid tax (under sec. 996(g)) on D.I.S.C. distributions is effective on June 22, 1984.”).