



BDO Seidman, LLP
Accountants and Consultants

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Subject:

**Tax Saving
Alternative for U.S.
Exporters**

Tax Tips

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Introduction:

Clients and prospects with profitable export sales can realize permanent tax savings by utilizing an Interest Charge Domestic International Sales Corporation.

Summary:

For more than 30 years, the United States has offered significant tax benefits to U.S. exporters. In 2000, the Extraterritorial Income Exclusion (ETI) regime was enacted to encourage multinational corporations and U.S.-based exporters to maintain production activities in the United States. Due to punitive tariffs levied against U.S. industries because the ETI was ruled an illegal export subsidy by the World Trade Organization, the ETI benefit will be fully repealed for most taxpayers after 2006. While the American Jobs Creation Act of 2004 replaces the ETI with the Qualified Production Activates Deduction (QPAD), the QPAD tax benefits will not be fully phased in until tax years beginning in 2010. In the interim, clients and prospects that utilize the ETI may realize a decrease in their tax deductions.

An alternative to the ETI export tax benefit, the Interest Charge Domestic International Sales Corporation (DISC), has been in existence for more than 20 years. U.S. exporters can receive—through a domestic corporation qualifying as a DISC—tax treatment for their export income comparable to that afforded by many foreign countries to their exporters. The shareholders of the DISC, and not the entity itself, are subject to U.S. income tax.

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Details:

- The 2005 benefits realized through a DISC structure generally are 200 percent greater than the ETI benefits on the same export sales. The DISC/ETI tax benefit gap will increase as the ETI is being phased-out.
- The dividends from a DISC generally qualify for the 15 percent dividend tax rate.
- U.S. exporter commission payments to the DISC entity are fully deductible, perhaps at a 35 percent effective tax rate.
- The 20 percent tax rate arbitrage between the U.S. exporter's deduction and the DISC shareholder dividends is a permanent tax savings available through 2008.
- All entity types can utilize the DISC structure, and in some cases may be preferable in a pass-through entity setting.
- Individuals, S-corporations, Partnerships, LLCs and other taxpayers can be DISC shareholders.
- The DISC structure is ideal for small and mid-sized closely held companies with profitable export sales.
- The new Qualified Production Activities Deduction is available for companies utilizing a DISC.

Timing:

The repeal of the ETI and termination of the 15 percent qualified dividend rate present a unique opportunity for closely held client and prospect companies with export sales. Through 2008, companies utilizing the DISC structure can deduct DISC commissions while the shareholders pay only 15 percent tax on the dividends. While it is preferable to implement a DISC structure on the first day of the company's tax year, a DISC can be formed mid-year and still exceed ETI benefits.

Recommended Action Steps:

- Review sales data for profitable exports.
- If currently utilizing the ETI, consider forming a DISC.
- Assess alternatives for maximizing ETI or DISC export tax benefits.
- Consult an export tax incentive specialist for assistance.

FOR MORE INFORMATION

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