

## MAXIMIZING RETIREMENT AND ESTATE PLANNING WITH THE IC-DISC

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### INTRODUCTION

The interest charge domestic international sales corporation (DISC or IC-DISC) is a congressionally sanctioned tax incentive. The IC-DISC has been a prominent income tax planning tool for U.S. export companies and their shareholders. According to a recent estimate by the Joint Committee on Taxation, total tax savings for taxpayers that take advantage of the IC-DISC program for the subsequent 10 years are expected to be \$5.3 billion.<sup>1</sup> Recent appellate cases have now opened the door for the use of the IC-DISC in retirement and estate planning.

### I. IC-DISC OVERVIEW

Sections 991 through 997 of the Internal Revenue Code govern the tax treatment of IC-DISCs. An IC-DISC is a stand-alone domestic corporate entity. In a typical structure, the IC-DISC is organized by the same owners as an existing domestic company that is in the business of manufacturing products that are exported for use outside the United States (Related Supplier). The Related Supplier pays a commission<sup>2</sup> to the IC-DISC based

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<sup>1</sup> See Staff of Joint Comm. on Tax'n, JCX-62-17 (Dec. 1, 2017).

<sup>2</sup> The IC-DISC may alternatively be set up as an entity that purchases export products from the Related Supplier and, in its own name, exports the products to customers outside the United States.

on the intercompany pricing rules of § 994. These rules generally relax the transfer pricing rules of § 482.<sup>3</sup> The commission payment from the Related Supplier to the IC-DISC creates a tax deduction for the Related Supplier, reducing the taxable income of the Related Supplier.

Where the statutory requirements<sup>4</sup> of an IC-DISC are met, the IC-DISC entity is not subject to federal income tax<sup>5</sup> when it receives commissions from the Related Supplier, making the IC-DISC effectively a tax-exempt entity. Distributions made by the IC-DISC company to its shareholders are taxable to each shareholder as dividends in the year received by the shareholder.<sup>6</sup> This dividend is eligible for qualified dividend income treatment.

The IC-DISC is not required to have substance at the corporate level in order to take advantage of these tax benefits, as explicitly contemplated by Congress.<sup>7</sup> Consistent with congressional intent, the IC-DISC

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<sup>3</sup> Section 994 provides that the transfer price to be paid by the Related Supplier to the IC-DISC cannot exceed the greatest of: (1) four percent of the qualified export receipts on the sale of such property by the DISC, plus 10 percent of the export promotion expenses of the DISC attributable to such receipts, (2) 50 percent of the combined taxable income of the DISC and the Related Supplier attributable to the qualified export receipts on such property derived as the result of a sale by the DISC, plus 10 percent of the export promotion expenses of the DISC attributable to such receipts, or (3) taxable income based upon the sales price actually charged (but subject to the rules in § 482).

<sup>4</sup> The statutory requirements of an IC-DISC are provided in § 992 and Regulation § 1.992-1. The statute requires that (1) the corporation be incorporated and existing under the laws of any state or the District of Columbia; (2) 95 percent of the gross receipts of the corporation qualify as qualified export receipts as defined in § 993(a); (3) the adjusted bases of the qualified export assets (as defined in § 993(b)) of the corporation at the close of the taxable year equal or exceed 95 percent of the sum of the adjusted bases of all assets of the corporation at the close of the taxable year; (4) the corporation make an election to be an IC-DISC by timely filing IRS Form 4876-A; (5) the corporation maintain its own books and records; (6) the corporation not be an “ineligible corporation” as defined in § 992(d); and (7) the corporation have a single class of stock with a par or stated value of at least \$2,500 on each day of the tax year (or, for the first year, on the last day of the tax year).

<sup>5</sup> I.R.C. § 991.

<sup>6</sup> To the extent earnings of the IC-DISC are retained by the company, shareholders are subject to an interest charge on the tax that the shareholders would have incurred if such amounts were distributed by the IC-DISC. § 995(f).

<sup>7</sup> See H.R. Rep. No. 92-533, at 60 (1971), stating,

[T]o qualify as a DISC, a corporation must have at least \$2,500 of capital (on each day of the taxable year as measured by the par or stated values of its outstanding stock). This test is designed to make sure that a corporation may qualify as a DISC even though it has relatively little capital. It is recognized that this rule constitutes a relaxation of the general rules of corporate substance. The separate incorporation of a DISC is required to make it possible to keep a better record of the export profits to which tax deferral is granted, but this does not necessitate in all other respects the separate relationships which otherwise would exist

regulations state that the application of the pricing rules under § 994, “do not depend on the extent to which the DISC performs substantial economic functions.”<sup>8</sup> The regulations further state that the “DISC need not have employees or perform any specific function.”<sup>9</sup> Because the DISC may be set up as a “paper” company, the DISC structure produces tax savings without necessitating changes to the operations, business contracts, or any other business-related transactions between the operating company and its customers, vendors, or employees.

## II. PLANNING WITH THE IC-DISC FOLLOWING *SUMMA HOLDINGS*

In addition to the income tax benefits described above, the IC-DISC may now provide an even greater benefit for use in retirement and estate planning following the Sixth Circuit Court of Appeal’s reversal of the Tax Court’s opinion in *Summa Holdings, Inc. v. Commissioner*.<sup>10</sup> In *Summa Holdings*, taxpayer James Benenson, Jr. (James Jr.), was a shareholder of Summa Holdings, Inc., the parent corporation of a consolidated group of manufacturing companies that make a wide variety of industrial products.<sup>11</sup> As a domestic manufacturing company that exported products, the shareholders of Summa Holdings were ideal candidates to take advantage of the IC-DISC rules.

In establishing the IC-DISC, James Jr. took the planning a step further. As part of the overall plan, individual retirement accounts that qualified as Roth IRAs were first established for James Benenson III (James III) and Clement Benenson (Clement), the children of James Jr. (collectively, the Benenson Children). The Benenson Children funded their respective Roth IRA accounts with the minimum amount of cash required to fund the IC-DISC entity.<sup>12</sup> The Roth IRA then established, and became the indirect shareholder of, the IC-DISC entity. From 2002 through 2008, the Benensons transferred \$5,182,314 to the Roth IRAs.

This structure resulted in two major tax benefits for the Benenson family. First, the structure provided the Benenson Children the ability to super-fund their Roth IRA accounts. Because withdrawals from a Roth IRA

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between a parent corporation and its subsidiary. This, however, is not intended to lessen the general rules of corporate substance required for other corporations in other contexts.

<sup>8</sup> Treas. Reg. § 1.994-1(a)(2).

<sup>9</sup> Treas. Reg. § 1.993-1(l)(1).

<sup>10</sup> 848 F.3d 779 (6th Cir. 2017), *rev’g* 109 T.C.M. (CCH) 1612 (2015).

<sup>11</sup> *See Summa Holdings, Inc. v. Comm’r*, 109 T.C.M. (CCH) 1612 (2015).

<sup>12</sup> James III and Clement transferred \$3,500 to their respective Roth IRAs and made no additional contributions.

are not taxable,<sup>13</sup> the Benensons could accumulate tax-free income. While the setup and tax-free accumulation of income via a Roth IRA is available to most taxpayers, contribution limits to Roth IRAs greatly limit the available tax advantage in the majority of cases.<sup>14</sup> However, in this case, with the Roth IRA owning shares in the IC-DISC, and with the earnings of the IC-DISC determined by the statutory pricing rules under § 994, each Roth IRA was able to accumulate over \$3 million within a six-year period with a total capital contribution of only \$3,500.<sup>15</sup> Going forward, any future appreciation or income earned on the \$3 million while in the Roth IRA should be tax-free to the Benenson Children.

Second, the structure provides a gift and estate tax benefit. By virtue of the Benenson Children owning the shares in the IC-DISC, as opposed to ownership by James Jr., the amounts paid as commissions by Summa Holdings to the IC-DISC are able to bypass the estate of James Jr. without being subject to estate or gift tax. Under the facts of the case, approximately \$5 million was able to bypass the estate of James Jr. over six years.<sup>16</sup>

The IRS challenged the structure, principally under the substance-over-form doctrine, and the Tax Court found in favor of the IRS. The Tax Court recharacterized the payments that Summa Holdings made to the IC-DISC, treating the payments first as a deemed dividend from Summa Holdings to its shareholders, followed by a contribution to the Roth IRAs.<sup>17</sup> Under this recharacterization, the Tax Court determined that the deemed contributions to the Roth IRAs were to be characterized as excess contributions to the Roth IRAs, subject to a six-percent penalty under § 4973(a).

The taxpayers appealed the Tax Court decision, and in a series of related decisions, prevailed. The first case in the series involved the company, Summa Holdings, which was domiciled in the Sixth Circuit. In that case, the Court of Appeals reversed the Tax Court, holding that the

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<sup>13</sup> See I.R.C. § 408A(d). In addition, unlike traditional IRAs, Roth IRAs are not subject to required minimum distribution rules, allowing further tax-free income accumulation.

<sup>14</sup> I.R.C. § 4973(f).

<sup>15</sup> See *Summa Holdings, Inc. v. Comm’r*, 109 T.C.M. (CCH) 1612 (2015).

<sup>16</sup> As noted by the Second Circuit Court of Appeals, the IRS never maintained that the transactions concealed the economic reality of untaxed gifts from James Jr. to his sons. Specifically, the IRS noticed there was no gift tax. See *Benenson v. Comm’r*, 910 F.3d 690, note 5. The IRS stated in a prior ruling that a DISC organized by the taxpayer and then transferred to the taxpayer’s children creates a deemed gift subject to gift tax, in the amount of the commission paid to the DISC company. See *Rev. Rul. 81-54*, 1981-1 C.B. 476. Based on the holdings in *Summa Holdings* and *Benenson*, as well as in *Hellweg v. Commissioner*, 101 T.C.M. (CCH) 1261 (2011) (in a case involving IRA ownership of a DISC, holding that the IRS may not characterize the same transaction differently for income tax and excise tax purposes), it would appear unlikely that the IRS would be successful in litigating a case under the deemed gift position articulated in Revenue Ruling. 81-54.

<sup>17</sup> See *Summa Holdings, Inc. v. Comm’r*, 109 T.C.M. (CCH) 1612 (2015).

Code explicitly allows Summa Holdings and the Benensons to enter into the transaction and to obtain the tax benefits that they claimed.

Two factors led to the court's conclusion. First, the Court of Appeals recognized that § 995(g) permits tax-exempt entities, such as IRAs, to own DISC shares.<sup>18</sup> Therefore, Congress expressly contemplated a structure in which an IC-DISC is owned by an IRA. Furthermore, while § 995(g) contemplates IRA ownership of an IC-DISC, and not explicitly "Roth" IRA ownership, § 408A requires the IRS to treat Roth IRAs in the same manner as traditional IRAs unless a specific provision of the Code provides otherwise.<sup>19</sup> The court held that when it comes to DISC dividends, the Code does not provide for differing treatment between a traditional IRA and a Roth IRA, and therefore a difference in treatment is not allowed.

Second, and critically, the IC-DISC structure does not require substance at the corporate level, undermining the Tax Court's re-characterization under the substance-over-form doctrine. As the Sixth Circuit Court of Appeals stated,

these economic-substance principles—which undergird the traditional use of the substance-over-form doctrine—do not give the Commissioner purchasing power here. Congress designed DISCs to enable exporters to defer corporate income tax. The Code authorizes companies to create DISCs as shell corporations that can receive commissions and pay dividends that have no economic substance at all...by congressional design, DISCs are all form and no substance, making it inappropriate to tag Summa Holdings with a substance-over-form complaint with respect to its use of DISCs.<sup>20</sup>

Therefore, because the IC-DISC structure does not require substance, the court held that the IRS is unable to reclassify the Benenson transaction using the substance-over-form doctrine.

In related shareholder-level cases for the Benenson family, the First Circuit<sup>21</sup> and Second Circuit<sup>22</sup> Courts of Appeal reached the same conclusion as the Sixth Circuit. Again, the courts of appeals relied on the fact that the IC-DISC, as a congressionally sanctioned entity, does not

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<sup>18</sup> *Summa Holdings, Inc. v. Comm'r*, 848 F.3d 779, 783 (6th Cir. 2017).

<sup>19</sup> See I.R.C. § 408A(a).

<sup>20</sup> *Summa Holdings, Inc.*, 848 F.3d at 786.

<sup>21</sup> The First Circuit case, was an appeal by Clement and James III, both residents in the First Circuit. *Benenson v. Comm'r*, 887 F.3d 511 (1st Cir. 2018)

<sup>22</sup> The Second Circuit case was an appeal by James Jr. and his wife Sharen, residents in the Second Circuit. *Benenson v. Comm'r*, 910 F.3d 690 (2d Cir. 2018),

require any substance. As stated by the First Circuit Court of Appeals, “By design, Congress and the Treasury Department allowed domestic companies to defer taxation and pay out dividends to shareholders through a structure that might otherwise run afoul of the Code.”<sup>23</sup>

The Second Circuit Court of Appeals reached the same conclusion, with similar reasoning. In finding the substance-over-form doctrine inapplicable, the court stated,

Congress has itself elevated form over substance insofar as DISC commissions are concerned by affording exporters “commission” deductions for payments that lack the economic substance generally associated with commissions, *i.e.*, some services rendered by the payees.<sup>24</sup>

#### CONCLUSION

Since enactment of the IC-DISC legislation, the IC-DISC has provided income tax benefits for export companies and their shareholders. The recent *Summa Holdings* and the related *Benenson* cases offer an opportunity to expand and enhance the tax benefits for shareholders that use IC-DISC companies.

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<sup>23</sup> *Benenson v. Comm’r*, 887 F.3d at 518, citing *Addison Int’l, Inc. v. Comm’r*, 90 T.C. 1207, 1221 (1988); *see also Summa Holdings, Inc.*, 848 F.3d at 786.

<sup>24</sup> *Benenson v. Comm’r*, 910 F.3d at 701-02.