



# IC-DISC Consumer Awareness Guide

The 4 Biggest (and Likely Unknown)  
Dangers of Your Existing IC-DISC



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Since dividend rates were scheduled to expire in 2010 and again in 2012, the IC-DISC has been under a cloud of uncertainty for many years. Now that the preferential dividend rates no longer have a “sunset” provision, more and more companies have established IC-DISCs.

Unfortunately, many of the existing IC-DISCs have significant risk exposure that the owners of IC-DISCs are typically unaware of. Even worse, the firms that have the ability to educate people on these risks do not seem interested in doing so. This guide was created to bring awareness to IC-DISC owners that these 4 Dangers are real and they can be devastating.

## 4 BIGGEST DANGERS THAT EXISTING IC-DISC OWNERS FACE TODAY:

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- 1.** Your IC-DISC may be in a “Disqualified” status and you are not aware of it.
- 2.** You may face substantial financial exposure if your IC-DISC is audited.
- 3.** You may be getting only a fraction of the possible IC-DISC tax savings.
- 4.** Your IC-DISC bank account may NOT be under your full and complete control.

### High-level Solution:

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IC-DISC owners typically have limited IC-DISC expertise and have no idea that they are exposed to these risks. They must first become AWARE before these risks can be effectively addressed. Once educated, the IC-DISC owners can then take proactive steps to reduce (and perhaps eliminate) these 4 Biggest Dangers.

# Danger #1:

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Unlike other corporate structures that the IRS recognizes (C-Corp, S-Corp, LLC, Partnership), the IC-DISC is very different. It is different in two general ways: a) Initial establishment of the IC-DISC and b) Ongoing maintenance of the IC-DISC.

- The rules to establish an IC-DISC are different than other entities, including time-sensitive requirements. If your IC-DISC did not meet these initial qualifications, it was never a qualified IC-DISC to begin with. What does this mean? This means that IC-DISC tax savings from a Disqualified IC-DISC are at risk of being nullified if the IC-DISC is audited. If the IRS determines that the IC-DISC was Disqualified since inception, the consequences can be disastrous and may include the requirement to repay the IRS hundreds of thousands of dollars in tax savings, as well as corresponding penalties and interest.
- The rules to maintain the “qualified” status of an IC-DISC are different than other entity types such as those for a C-Corp, S-Corp, LLC, or Partnership. The IRS has requirements for specific annual actions as well as ongoing annual testing requirements that other entities do NOT require. If the IC-DISC fails to meet the ongoing requirements for actions and testing, it will become disqualified.

Additionally, once the IC-DISC becomes Disqualified, it will remain Disqualified. The impact of this is that in the year of Disqualification and thereafter, the IC-DISC is not able to create tax savings. Any tax savings that are claimed may be at risk if the IC-DISC is audited. In some circumstances it may be possible to Requalify the DISC.

Even if the DISC can be Re-qualified, it is typically a time-consuming and expensive process. If Requalification is even possible (and financially feasible), the process cannot be initiated unless you first are aware of the initial disqualification.

## What is the takeaway?

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Be certain that your IC-DISC was Qualified at inception and has maintained its Qualified status since inception.

## Danger #2:

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This is different than the risk of a Disqualified IC-DISC (as described in Danger #1 above). In this situation your IC-DISC is in fact Qualified, but the danger is that you are exposed to the financial burden of defending the IC-DISC return if it is audited.

Although it is possible that the firm that prepared your IC-DISC return will defend it if audited by the IRS, it will likely be at an hourly rate (i.e. the IC-DISC owner will bear the financial burden for the defense of the return). In some instances, an IC-DISC tax preparation firm charges a relatively modest fee to prepare the IC-DISC tax return, but their cost to defend the return is more than 10 times the cost to prepare the original IC-DISC return!

This typically is the result of the IC-DISC tax preparer not being a true IC-DISC expert. Because of their lack of expertise, the tax firm ends up gaining the necessary knowledge during the audit. Or said another way, you are footing the bill for the firm to become adequately educated on the IC-DISC.

Even if the tax firm already possesses adequate knowledge, there will still be a cost in terms of their time to defend you. It is unusual to find an IC-DISC tax preparation firm that is willingly to stand behind the work and defend the audit at no extra cost to you. Although not the norm, it is possible to find a firm that will be willing to shift the financial risk from you to them and take on the audit defense.

## What is the takeaway?

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- Be aware of the financial risks you currently have if the IC-DISC is audited, and
- Decide if that is a risk that you wish to retain or not. If you do not wish to retain it, you should find a firm who will shift that risk from you to them.

## Danger #3:

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Generally speaking, there are two ways to calculate the IC-DISC tax savings: The “Simple” method and the “Transaction-by-Transaction” (“TxT”) method. Why should you care about the difference between a Simple Calculation and a TxT Calculation? Because a Simple Calculation typically captures less than 1/3 of the tax savings available from a TxT Calculation. In other words, the TxT Calculation typically results in tax savings that are more than 3 TIMES greater than the Simple Calculation.

There are many tax preparation firms that claim to have the necessary expertise to prepare IC-DISC tax returns. Most of those possess neither the IC-DISC expertise nor the necessary software to perform a Comprehensive TxT Calculation. Even worse, there are some firms that claim to be able to perform a TxT Calculation, but they really are just doing a modified Simple Calculation and calling it TxT.

Here are the economics of Simple Calculations vs. TxT Calculations:

- Although on average the TxT Calculation results in 3 times the tax savings, it typically requires substantially more than 3 times the amount of time by the tax firm to capture the incremental TxT tax savings. Additionally, to perform Comprehensive TxT Calculations, the firm typically has invested tens (or even hundreds) of thousands of dollars in specialty software and other intellectual property that must be recouped.
- Even though TxT typically results in 3 times the tax savings, it is not unusual for the firm performing the TxT work to charge at least 5 times more in fees. This is because of the substantially higher costs incurred by the tax firm – not only in time, but the need to recoup their Intellectual Property investment costs. Thus, for some IC-DISC clients the TxT calculation will not be financially attractive.
- Even though the TxT Calculation is not attractive for all IC-DISC clients, the client should at least be made aware that the TxT option exists and have the opportunity to make an informed decision on whether the likely incremental tax savings are worth the incremental costs of TxT.

## What is the takeaway?

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- Insist that your IC-DISC tax return preparer provide you an estimate of the increased tax savings from a TxT Calculation along with an estimate of the additional fees. If your provider is not willing to do this, find another tax preparer who will.
- Many tax firms who claim to be able to do a TxT Calculation are really just doing a Modified Simple Calculation. It can be very difficult to accurately distinguish between the firms who truly do TxT and the ones who only claim this ability.

## Danger #4:

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To be fair, most IC-DISC tax preparation firms believe that you should control your own bank account. However, enough firms engage in this practice that it warrants discussion.

It is not unusual for companies who have an IC-DISC to annually pay millions of dollars of IC-DISC commission to the IC-DISC. Additionally, the amount of IC-DISC commissions paid may represent a large portion of a company's current working capital. What would happen if the firm controlling your IC-DISC bank account did not return that money in a timely fashion? For most businesses, that would be devastating.

Additionally, even if the IC-DISC tax preparation did return the money timely, it may take several days to facilitate because the IC-DISC bank account may be with a different bank in a different state than the related corporation's bank accounts.

You should have 100% control over your IC-DISC bank account. It is also helpful to keep the IC-DISC bank account at the same bank as the corporation's operating bank accounts. This typically allows the IC-DISC bank account to be "linked" with the other bank accounts on the bank's online banking platform.

The benefit to having the DISC bank account linked to the operating accounts is that it is often easier, faster, and cheaper to make the IC-DISC bank account transactions.

## What is the takeaway?

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- Maintain 100% control over your IC-DISC bank account and never surrender control.
- Have the IC-DISC bank account at the same bank as the corporation's other bank accounts so that the IC-DISC bank account can be "linked" for fast, easy, and low-cost IC-DISC transactions.

## Takeaway Checklist:

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- ❑ Be certain that your IC-DISC has been Qualified since inception.
- ❑ Be aware of the financial risk you currently have if the IC-DISC is audited, and decide if that is a risk that you wish to retain or not. If you do not wish to retain it, it is imperative that you find a firm that will shift that risk from you to them.
- ❑ Insist that your IC-DISC tax return preparer provide you an estimate of the increased tax savings from performing a TxT calculation along with an estimate of the additional fees. If your provider is not willing to do this, find another tax preparer who is willing.
- ❑ Many of the IC-DISC tax preparation firms who claim to have the ability to provide a Comprehensive TxT Calculation do not actually have that ability. It can be very difficult for a client to assess whether or not firm can actually perform a Comprehensive TxT Calculation.
- ❑ Maintain 100% control over your IC-DISC bank account.
- ❑ Have the IC-DISC bank account at the same bank as the corporation's other bank accounts so that the IC-DISC bank account can be "linked" for faster, easier, and cheaper IC-DISC transactions.

### Who is Export Advisors?

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Export Advisors (EA) has helped hundreds of clients collectively save more than \$100 million through the effective use of the IC-DISC program. Our philosophy is that rather than being an IC-DISC provider, we seek to be your IC-DISC Partner™.

Our service offering was designed not only to substantially reduce (and perhaps eliminate) the 4 Dangers detailed in this guide, but also to provide a uniquely compelling value proposition.

The information provided in this guide reflects solely the beliefs and opinions of David Spray. It is based on his experience in helping hundreds of IC-DISC companies and their owners. It is not meant to provide legal or tax advice. The information may or may not be relevant for your specific example. If you want to explore a relationship with Export Advisors, please contact David Spray at 832.654.9889 or [dspray@exportadvisors.com](mailto:dspray@exportadvisors.com).