

TAX INSIGHTS



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STOCK UP ON INVENTORY TAX SAVINGS

What can manufacturers do to increase their savings and improve their financial health?

United States manufacturers face inflationary pressures, a weak dollar, growing foreign demand and stagnant domestic sales. Implementing the Last-In, First-Out (LIFO) method for accounting, and establishing an IC-DISC (Interest Charge-Domestic International Sales Corporation) entity are two options available to manufacturers for improving their financial health in the current economic environment.

The LIFO method lets manufacturers use the price of the most-recently purchased inventory (Last-In) as a basis for determining the cost of goods sold (First-Out). Since the newest inventory is usually the most expensive, using the LIFO method enables a manufacturer to declare smaller net profits on goods sold, leading to lower taxes and providing relief against inflation.

Specific circumstances and potential benefits vary from one manufacturer to another, based on the type of inventory purchased, industry, regional location and other factors. Technological components, for example, typically decline in price over time, making LIFO an unfavorable method for assigning value to such inventory purchases. Oil, steel and other items, though, have been facing continuous price increases. Companies operating within specific global industries, such as aerospace, must likewise make substantial allowances for inflation in all aspects of financial and production planning. In these cases, the LIFO method would be highly beneficial and provide enhanced cash flow to companies.

A variety of means are available for determining LIFO inventory, including a simplified method based on the U.S. Bureau of Labor and Statistics' Producers Price Indexes (PPI) data, whose formulations account for inflationary pressures on manufactured items. Accounting and tax professionals can help determine the most advantageous strategies for applying the LIFO method.

In addition to LIFO, another long-established option available to manufacturers for reducing corporate income tax is forming an IC-DISC. The IC-DISC was enacted by Congress in 1971 as the Domestic International Sales Corporation (DISC) to help



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businesses combat a growing U.S. trade deficit. The DISC was then revised in 1984 as the IC-DISC. With the recent demise of other U.S. export incentives, the IC-DISC is attracting renewed interest as an opportunity for companies engaged in export sales to benefit from lower corporate taxes.

An IC-DISC exists as a separate entity from the parent company, with its ownership comprised of the exporting parent company or the parent company shareholders. The IC-DISC requires a minimum capitalization of \$2,500. In its simplest form, the IC-DISC can earn a commission based on export sales based on either four percent of gross receipts or 50 percent of net foreign sales income. Corporate taxes are then deferred on this commission income earned by the IC-DISC. Up to \$10 million per year in export sales can be conducted by the IC-DISC.

In case the IC-DISC is held by individuals, commissions received by the IC-DISC can be distributed to its shareholders as dividends, which are then taxed at the individual dividend rate of 15 percent. Those dividends can be distributed in lieu of annual bonuses or performance incentives.

EXPORT PRODUCTS SOLD THROUGH THE IC-DISC MUST BE EXTRACTED, GROWN OR MANUFACTURED IN THE UNITED STATES.

Commissions paid to the IC-DISC significantly reduce the net profits subject to corporate income tax by the parent entity. That creates a 35 percent tax benefit for the parent company on commission payments made to the IC-DISC.

Export products sold through the IC-DISC must be extracted, grown or manufactured in the United States. Products must also be held for consumption, direct use, sale, lease or rental outside of the United States. Manufacturers must consider other factors as well, including whether to base overall commissions on net income, gross receipts, and can perform transaction by transaction analysis to maximize the most appropriate basis for commission payments for each sale.

Amidst the current domestic and international economic environments, the potential benefits of an IC-DISC merit evaluation, as do the possible tax savings associated with using the LIFO method for determining inventory value. Congress is currently evaluating the benefits of these two tax devices. As a result, these benefits could be enhanced or reduced in conjunction with Congress' contemplated corporation income tax reform.

OTHER FACTORS TO CONSIDER BEFORE ADOPTING LIFO

Although implementing LIFO can bring significant benefits, there are also macroeconomic and accounting factors to consider before making a LIFO conversion. The following occurrences could negatively affect manufacturers who adopt the LIFO method:

- *Drop in inventory prices*
- *Reduction in company inventory or large productivity gains leading to lower work in process and finished products*
- *Conversion to IFRS standards which currently do not allow LIFO as a permissible accounting method*
- *Adoption of just-in-time manufacturing or other business process re-engineering implementation resulting in drastic reduction in inventory levels*

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