



STATE OF CALIFORNIA
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Date: February 1, 2006
 Case: *****
 Case Unit: *****
 In reply refer to: 371:CKL

Regarding: *****

Dear *****:

This is in response to your letter of ***** , in which you asked various questions about the California treatment of DISC corporations. As you surmised, California does not conform to federal law with respect to DISCs but rather treats them as it does any C corporation. The Department does not have a publication with respect to the California treatment of DISCs. I will respond to your specific questions in the order you have presented them.

1. Must a DISC be combined with its related manufacturing supplier under unitary rules?

If the DISC and its supplier meet the tests for unity they must be combined.

2. Are commission and interest expenses paid by the related supplier to its DISC allowable under CA law and eliminated under combined return rules or are they disallowed on the related supplier return and a combined return is not appropriate?

If the DISC and its supplier were unitary, intercompany commissions and interest payments would be eliminated from the combined report. If they were not unitary and the supplier filed a CA return the expenses would be deductible.

3. Are dividends received from a CA or non-CA DISC taxable to a CA resident? Earnings and Profits of the DISC are derived from income pursuant to federal DISC law which CA does not follow.

Dividends from a CA or non-CA DISC are taxable to a CA resident just as dividends from a C corporation would be.

4. If the related supplier is an S Corporation, how must it report its expenses to a DISC? Is a combined return with the DISC required?

An S Corporation may not be included in a combined report. Rev. and Tax. Code section 23801(c). Deductions allowable to an S Corporation are set forth in Rev. and Tax Code section 23800 *et.seq.*

5. If the DISC is a non-CA corporation and it has no CA nexus, does this change the character of the dividends it pays to CA residents or CA corporations?

No. The domicile or place of incorporation of the DISC has no bearing on the character of the dividends paid to a CA resident or corporation. Before the decision in *Farmer Bros. Co. v. Franchise Tax Board* (2003) 108 Cal.App. 4th 976, holding that Rev. and Tax. Code section 24402 violated the Commerce Clause of the United States Constitution by discriminating against corporations engaged in interstate commerce, a deduction was allowed under that section to a corporate payee to the extent the dividend income had been included in income subject to CA tax.

6. Might the separate existence of the DISC be disregarded and treated similar to the way Qualified Subchapter S Subsidiaries (QSSS) are treated?

If the DISC is a member of a unitary group its income and factors will be included in the combined report. California has no provisions for disregarding the separate existence of a DISC.

Please note that I have given general answers to general questions. As a rule, the department requires a representation that you are not being audited and also requires that the facts of your situation be supplied, along with the appropriate research. I hope this is helpful to you.

Very truly yours,

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