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06.19.15

Legal Ruling - 2015 - 02

**SUBJECT: California Treatment of Transactions Involving
Interest Charged Domestic International Sales Corporations
Owned by Persons not Included in a Combined Report**

ISSUE

What is the proper treatment for California tax purposes of transactions between corporations designated as an IC DISC for federal tax purposes, and its owner(s)?

BACKGROUND

Interest Charged Domestic International Sales Corporations (IC DISCs) were created by the U.S. Congress to spur exports of American goods. Pursuant to Internal Revenue Code (IRC) section 991, IC DISCs are not directly subject to federal tax. Instead, the owners of IC DISCs are subject to tax on the earnings and profits of an IC DISC. Owners are taxed on the earnings and profits of an IC DISC whether or not the IC DISC makes a distribution to its owners. As a result, owners are treated as receiving a deemed distribution from the IC DISC under federal law. If an IC DISC owner is an individual, the dividends are subject to tax at the rate applied to capital gains pursuant to IRC section 1(h)(11). For this reason, IC DISCs are often owned by pass-through entities such as S corporations, limited liability companies (LLCs) and partnerships, so that the deemed distribution income from the IC DISC is passed through to S corporation shareholders, members, or partners as the case might be.

IC DISCs generally do not have any employees or actual operations; they are merely structured under the federally created tax savings mechanism. Income is attributable to IC DISCs in two ways. In the first situation, the owner of an IC DISC sells goods offshore and attributes the sales to the IC DISC through a series of entries on the IC DISC's books and records. The title to the goods sold offshore is not transferred to the IC DISC. The profits from the attributed sales of the goods are reflected in the IC DISC's earnings and profits, which are deemed to be distributed to the owner of the IC DISC. Under IRC section

995(b)(1)(E), profits from the first \$10 million of export revenues are not included in the IC DISC's earnings and profits. Thus, these profits are not included in the deemed distribution to the IC DISC's owner. This represents an additional tax deferral mechanism arising from the IC DISC. Notwithstanding this deferral mechanism, however, the IC DISC owner is subject to an "interest charge" on the amount of the tax savings relating to the deferral. The IC DISC owner must calculate the difference of its tax liability attributable to the income that is deferred and, pursuant to IRC section 995(f)(1)(B), must pay interest based on the Treasury Bill rate multiplied by the tax savings.

The second way that income may be attributable to an IC DISC arises in situations when an owner, or another C corporation owned by the IC DISC owner, pays a commission to the IC DISC for acting as a broker for sales made by the IC DISC. Again, because IC DISCs generally do not have any employees or actual operations, the IC DISC does not actually act as a broker. Nevertheless, the commission income of the IC DISC is included in its earnings and profits. However, for federal tax purposes, the owner of the IC DISC, or the C corporation owned by the IC DISC owner, is allowed a deduction for the commission that it paid to the IC DISC. In some instances, cash is actually transferred between the IC DISC' and its owner or the C corporation owned by the IC DISC owner and the IC DISC, representing the commission. Eventually, these amounts are distributed back to the IC DISC owner and taxed at the capital gains rate.

Generally, because transactions between an IC DISC and its owner consist only of entries on the IC DISC's books and records, those transactions lack true economic substance. Even in instances where there is a cash payment pertaining to a commission, the underlying transaction lacks economic substance.

SITUATION ONE

Mr. A and Ms. B, California residents, are the sole and equal shareholders in TMNT, Inc., which has elected to be treated as an S corporation for both federal and California purposes. TMNT, Inc. operates cotton fields in California. TMNT-DISC, Inc. is a wholly owned subsidiary of TMNT, Inc. To take advantage of federal tax savings, all of TMNT, Inc.'s foreign sales are sold to buyers through TMNT-DISC, Inc., which is a C corporation, registered in California. During 2015, \$1 million of TMNT, Inc.'s cotton crop is sold offshore through TMNT-DISC, Inc.

SITUATION TWO

Mr. C, a California resident, is the sole member of Brown Acres, LLC. Brown Acres, LLC operates an asparagus field in California. To take advantage of federal tax savings, Brown Acres, LLC formed a wholly-owned IC DISC, Brown Acres-DISC, Inc., which is a C corporation registered to conduct business in California. During 2015, Brown Acres, LLC paid a \$100,000 commission to Brown Acres-DISC, Inc. for Brown Acres-DISC, Inc. acting as a broker for Brown Acres, LLC's foreign sales.

SITUATION THREE

Mr. D and Mr. E, California residents, are equal partners in LZ, a general partnership. LZ operates a vineyard in California. To take advantage of federal tax savings, all of LZ's foreign sales are sold through its wholly-owned IC DISC, LZ-DISC, Inc., which is a C Corporation, registered in California. During 2015, \$1 million of LZ's grape crop is sold offshore through LZ-DISC, Inc.

SITUATION FOUR

Ms. F, a California resident, operates an almond orchard in California. To take advantage of federal tax savings, all of Ms. F's foreign sales from her almond orchard are sold through her wholly-owned IC DISC, F-DISC, Inc., which is a C corporation, registered in California. During 2015, \$250,000 of Ms. F's almond crop is sold offshore through F-DISC, Inc.

SITUATION FIVE

Mr. G is the sole shareholder of Rice Growers, Inc., which is a C corporation and is registered in California. Rice Growers, Inc. operates a rice field. To take advantage of federal tax savings, Mr. G. formed a wholly-owned IC DISC, Rice Growers-DISC, Inc., which is a C corporation, registered in California. Rice Growers, Inc. paid a \$50,000 commission to Rice Growers-DISC, Inc. for Rice Growers-DISC, Inc. acting as a broker for Rice Growers, Inc.'s foreign sales.

LAW AND ANALYSIS

The IRC provisions relating to IC DISCs are contained in IRC sections 991 – 999. Pursuant to Revenue and Taxation Code¹ section 23051.5(b)(1), IC DISCs are not applicable for California purposes. However, in many instances, corporations that are designated as IC DISCs for federal tax purposes, and their owner(s), have a return-filing obligation with California.

If a corporation designated as an IC DISC for federal tax purposes and its owner are C corporations and included in the same combined report, the transactions between them will have no economic effect outside the combined report. In other words, the income attributable to the corporation that is designated as an IC DISC for federal tax purposes would effectively be offset by the cost of goods sold or expense attributable to its owner, resulting in no additional taxable income for California purposes. However, as set forth above, the owner(s) of an IC DISC may be pass-through entities or individuals. In such situations, the transactions between an IC DISC and its owner(s) will not have the effect of offsetting one another because the different types of entities are not included in the same combined report. Consequently, a corporation that is designated as an IC DISC for federal

¹ Further unattributed statutory references are to the Revenue and Taxation Code unless noted otherwise.

tax purposes may have income on its books and records that must be reported for California tax purposes, but because this income arises only from entries on the books and records of the corporation that is designated as an IC DISC for federal tax purposes, there is no underlying economic substance to the transactions generating the income. For tax purposes, reporting income that does not have any economic substance deviates from standard tax principles because items reported for tax purposes must possess an underlying economic substance. (See *Tower v. Commissioner*, (1946) 327 U.S. 280) With this in mind, guidance is needed to ensure that the income that lacks underlying economic substance pertaining to a corporation that is designated as an IC DISC for federal tax purposes is properly reported for California tax purposes.

Section 25102 states:

In the case of two or more persons, as defined in Section 19² of this Code, owned or controlled directly or indirectly by the same interests, the Franchise Tax Board may permit or require the filing of a combined report and such other information as it deems necessary and is authorized to impose the tax due under this part as through the combined entire net income was that of one person, *or to distribute, apportion, or allocate gross income or deductions between or among such persons, if it determines that such consolidation, distribution, apportionment, or allocation is necessary in order to reflect the proper income of such persons.* (Emphasis added.)

By its terms, section 25102 authorizes the Franchise Tax Board³ to allocate gross income and deductions between "persons," as that term is defined in section 19, that are directly or indirectly owned by the same interests if it is necessary to reflect the proper income of such "persons." The definition of "persons" includes corporations, which are the type of entities that are designated as an IC DISC for federal tax purposes, as well as various types of entities that own IC DISCs, and individuals. Thus, section 25102 grants the Franchise Tax Board the authority to allocate gross income and deductions between a corporation that is designated as an IC DISC for federal tax purposes and its owner(s).

² Section 19, in pertinent part, states:

"Person" includes any person, firm, partnership, general partner of a partnership, limited liability company, registered limited liability partnership, foreign limited liability partnership, association, corporation, company syndicate, estate, trust, or organization of any kind....

³ It is wholly within the Franchise Tax Board's discretion as to whether Revenue and Taxation Code section 25102 should be applied. (See *Handlery v. Franchise Tax Board*, (1972), 26 Cal.App.3rd 970, *Appeals of Pacific Coast Properties, Inc; Technion Construction Company and Laurelwood Co.* (1968) 68-SBE-048, November 20, 1968, and *Appeal of Chanticleer Investment Co.* (1975) 75-SBE-001 January 7, 1975.)

With respect to sales that are attributed to a corporation that is designated as an IC DISC for federal tax purposes, the Franchise Tax Board will allocate the sales on the books and records of the IC DISC to the owner(s) of the IC DISC because that is the person actually making the sales attributed to the IC DISC. With respect to situations where an IC DISC owner or a C corporation owned by the IC DISC owner has deducted a commission paid to the corporation that is designated as an IC DISC for federal tax purposes, the Franchise Tax Board will allocate the commission income of the IC DISC to its owner or the C corporation owned by the IC DISC owner. Once allocated, the commission income and expense will offset one another at the level of the IC DISC owner. In both of these instances, this treatment is necessary in order to reflect the proper income of the corporation that has been designated as an IC DISC for federal tax purposes and its owner(s), reflecting the economic substance of the transactions that generate the income for California tax purposes.

In circumstances where a corporation designated as an IC DISC for federal tax purposes has generated income or expenses that do not relate to its status as an IC DISC, those items of income and expense will not be subject to this Legal Ruling. Instead, those items will remain the income and expenses of the corporation designated as an IC DISC.

HOLDING – SITUATION ONE

The gross income from the offshore sales of the cotton crop that were attributed to TMNT-DISC, Inc. will be allocated to TMNT, Inc. As a result, TMNT-DISC, Inc. will not have any reportable taxable income for 2015 for California purposes. However, TMNT-DISC, Inc. is subject to the minimum franchise tax because it is registered in California. TMNT, Inc. must report the \$1 million of gross income from the offshore sales for purposes of calculating its S corporation income for California tax purposes.

HOLDING – SITUATION TWO

The commission income received by Brown Acres-DISC, Inc. will be allocated to Brown Acres, LLC. As a result, Brown Acres-DISC, Inc. does not have any reportable taxable income for 2015 for California tax purposes. However, Brown Acres-DISC, Inc. is subject to the minimum franchise tax because it is registered in California. The \$100,000 commission income of Brown Acres-DISC, Inc. that is allocated to Brown Acres LLC and commission expense of Brown Acres LLC offset one another for purposes of calculating the income of Brown Acres, LLC for California tax purposes.

HOLDING – SITUATION THREE

The gross income from the foreign sales of the grape crop that was attributed to LZ-DISC, Inc. will be allocated to LZ. As a result, LZ-DISC, Inc. does not have any reportable income for 2015 for California tax purposes. However, LZ-DISC, Inc. is subject to the minimum franchise tax because it is registered in California. LZ must report the gross income from

the offshore sales of LZ-DISC, Inc. for purposes of calculating its partnership income for California tax purposes.

HOLDING – SITUATION FOUR

The \$250,000 of gross income from the offshore sales pertaining to the almond crop that were attributed to F-DISC, Inc. will be allocated to Ms. F. Thus, F-DISC, Inc. does not have any reportable taxable income for 2015 for California tax purposes. However, F-DISC, Inc. will be subject to the minimum franchise tax because it is registered in California. Ms. F must report the \$250,000 of gross income from the offshore sales for purposes of calculating her income for California tax purposes.

HOLDING – SITUATION FIVE

The commission income received by Rice Growers-DISC, Inc. will be allocated to Rice Growers, Inc. As a result, Rice Growers-DISC, Inc. does not have any reportable taxable income for California tax purposes. However, Rice Growers-DISC, Inc. is subject to the minimum franchise tax because it is registered in California. The \$50,000 commission income of Rice Growers-DISC, Inc. that is allocated to Rice Growers, Inc. and the commission expense of Rice Growers, Inc. offset one another for purposes of calculating the income of Rice Growers, Inc. for California tax purposes.

DRAFTING INFORMATION

The principal author of this legal ruling is Craig Swieso of the Franchise Tax Board, Legal Division. For further information regarding this ruling, contact Mr. Swieso at the Franchise Tax Board, Legal Division, P.O. Box 1720, Rancho Cordova, California 95741-1720.