

California treatment of transactions between IC DISCs and their owners

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Overview

The California Franchise Tax Board (FTB) recently issued Legal Ruling (LR) 2015-02, which addresses California tax treatment of Interest Charge Domestic International Sales Corporations (IC DISCs).¹

California does not conform to Internal Revenue Code (IRC) §§ 991-997, which provide for the federal taxation of IC DISCs and their shareholders. The FTB has determined that “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.”² Using the authority granted to the FTB by California Revenue and Tax Code § 25102, the FTB has determined it has the authority to allocate gross income and deductions between the corporation (the IC DISC) and its owners (or other affiliated entities owned or controlled directly or indirectly by the same interests) in order to properly report income that the FTB views as lacking economic substance for California purposes.³

Except when an IC DISC and its owner, another C Corporation, are included within a combined return, it is the FTB’s position in LR 2015-02 that all of the IC DISC’s income is to be attributed to the owner of the IC DISC or other commonly controlled affiliates. The mechanics of the reallocation differ depending on the type of taxpayer that owns the IC DISC and the nature of the income attributable to the IC DISC.⁴

In LR 2015-02 the FTB held that if the owner of an IC DISC is a C Corporation and is included in a combined report, the income attributed to the IC DISC is offset by the cost of goods sold or expenses attributed to its owner, resulting in no additional California taxable income.⁵ If the owner is an individual or pass-through entity and the income is attributable to sales, the FTB will allocate the sales to the owner(s) of the IC DISC.⁶ If the income is a commission, the FTB will allocate the commission income to the owner(s), and then such income will be offset by the commission expense at the level of the IC DISC owner.⁷ For an IC DISC that does not file as a member of a combined return, the allocation causes the IC DISC to have no income or earnings and profits for purposes of California taxation. For an IC DISC organized under California law or registered with the California Secretary of State, the corporation designated as the IC DISC will be subject to the California minimum tax with the result generally being a liability of \$800.

In this Tax Alert we summarize LR 2015-02 and provide taxpayer considerations.

IC DISC background

IC DISCs were created by the US Congress to encourage the export of American goods.⁸ An IC DISC usually has no employees or actual operations and is not directly subject to federal taxation.⁹ Instead, the

¹ FTB Legal Ruling 2015-02 (Jun. 19, 2015), available [here](#).

² *Id.*

³ Cal. Rev. & Tax. Code § 25102 permits the FTB to allocate gross income and deductions between persons, as defined in Section 19, which 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.”

⁴ FTB Legal Ruling 2015-02, at 3.

⁵ *Id.*

⁶ *Id.* at 5.

⁷ *Id.*

⁸ I.R.C. §§ 991-997.

⁹ I.R.C. § 991.

owners of an IC DISC are taxed on the earnings and profits of the IC DISC, whether or not the IC DISC makes a distribution to its owners.¹⁰ Therefore, under federal law, owners are treated as receiving a deemed dividend distribution from the IC DISC.¹¹ If an IC DISC owner is an individual, the dividends are subject to tax at the capital gains rate under IRC § 1(h)(11).¹² Consequently, IC DISCs are often structured through ownership by pass-through entities, resulting in the deemed dividend distribution from the IC DISC flowing up to the individual owners where it is taxed at capital gains rates.¹³

Income is attributable to IC DISCs in two ways. In the first situation, the owner attributes offshore sales to the IC DISC through a series of entries on the IC DISC's books and records, with the profits from the first \$10 million of export revenue included in the IC DISC's earnings and profits (E&P), but excluded from the deemed dividend provisions.¹⁴ The income related to the first \$10 million of export revenue represents an additional tax deferral, though the owner is subject to an "interest charge" on the amount of tax savings related to the deferral.¹⁵ For purposes of federal income tax, title of the goods sold offshore (export sales) is not transferred to the IC DISC; however, the profits from the attributed sales are reflected in the IC DISC's earnings. The profits associated with more than \$10 million of export revenue are deemed distributed to the owner in the form of a dividend.

In the second situation, the owner pays a commission to the IC DISC for acting as a broker for sales made by the IC DISC.¹⁶ Because the IC DISC is generally a "shell" company without actual employees, the IC DISC does not actually act as a broker.¹⁷ Nevertheless, the commission income is reflected in the IC DISC's E&P.¹⁸ However, the owner of the IC DISC is allowed a deduction, on the owner's federal tax return, for the commission that it pays to the IC DISC.¹⁹ The commission income in excess of the commission associated with \$10 million of export revenue is deemed distributed to the owner in the form of a dividend.²⁰ In both cases, even if cash is actually transferred between the IC DISC and its owner(s), the FTB finds no economic substance to the transactions generating the income.²¹

California treatment of IC DISC transactions

LR 2015-02 formalizes the FTB's position with respect to California tax treatment of IC DISCs. Specifically, the FTB stated IC DISCs are not respected for California purposes, even though the corporations designated as IC DISCs and their owner(s) may have a filing obligation in California.²²

As previously noted, the FTB stated that if the owner of an IC DISC is a C Corporation and is included in a combined report, the income attributed to the IC DISC is offset by the cost of goods sold to its owner, resulting in no additional California taxable income.²³ However, the FTB recognized that most owners of IC DISCs are individuals or pass-through entities and as such are not subject to combined reporting. Without combined reporting, the transactions between an IC DISC and its owner(s) will not have the effect of offsetting one another.

¹⁰ I.R.C. § 991; FTB Legal Ruling 2015-02, at 1.

¹¹ FTB Legal Ruling 2015-02, at 1.

¹² *Id.*

¹³ *Id.*

¹⁴ FTB Legal Ruling 2015-02, at 2. Note that the LR states that for federal purposes a DISC that records sales as a buy-sell DISC excludes the income associated with the first \$10 million of sales from E&P. The income is included in E&P, but in certain DISC structures up to \$10 million of E&P may be deferred versus a deferral of only the income on the first \$10 million of sales. A discussion of the different DISC structures is not relevant for purposes of the effect of Legal Ruling 2015-02.

¹⁵ *Id.* (The IC DISC owner must calculate the difference of its tax liability attributable to that income that is deferred and pursuant to I.R.C. § 995(f)(1)(b), and pay interest based on the Treasury Bill rate multiplied by the tax savings).

¹⁶ FTB Legal Ruling 2015-02, at 2.

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.* at 4.

²² *Id.* at 3.

²³ *Id.*

For California purposes, the FTB has deemed the sales or commission income attributed to the IC DISC under federal tax law lacks economic substance.²⁴ Therefore, the sales are allocated to the owners of the IC DISC or commonly controlled entity that actually made the sales attributed to the IC DISC. If the IC DISC income is commission income, the commission income is allocated to the owner(s) or commonly controlled entity. In effect, this offsets the commission expense at either the level of the IC DISC owner or other controlled entity.²⁵

The FTB provided five examples in LR 2015-02:

1. Where an S Corporation is the owner of the IC DISC and the S Corporation attributes all of its foreign sales to the IC DISC, the FTB held the foreign sales income attributed to the IC DISC is allocated to the owner, the S Corporation, for purposes of determining its taxable income.
2. Where an LLC is the owner of the IC DISC and the LLC paid a commission to the IC DISC, the FTB held all of the commission income is allocated to the owner, the LLC, which offsets the LLC's commission expense for purposes of determining the LLC's California taxable income.
3. Where a partnership is the owner of the IC DISC and the partnership attributes its foreign sales to its IC DISC, the FTB held all of the foreign sales income is allocated to the owner, the partnership, in calculating its income for California tax purposes.
4. Where an individual is the owner of the IC DISC and the individual attributes all of his or her foreign sales to his or her IC DISC, the FTB held all of the foreign sales income is allocated to the individual.
5. Where a shareholder is the owner of both an IC DISC and a C Corporation and the C Corporation pays a commission to the IC DISC, the FTB held the IC DISC's commission income is allocated to the commonly controlled C Corporation, offsetting its commission expense when determining its taxable income.²⁶

In all instances, the FTB also held that if the IC DISC was registered in California, the IC DISC is subject to the California minimum franchise tax.²⁷

Taxpayer considerations

LR 2015-02 provides that California does not follow federal tax treatment of IC DISCs. FTB Legal Rulings are considered equivalent authority to an IRS Revenue Ruling, provide the FTB's interpretation of existing law, and have retroactive effect unless stated otherwise.²⁸ LR 2015-02 does not contain a statement limiting its retroactive effect. Accordingly, owners of IC DISCs or related affiliates, including partners, members, and shareholders of pass-through entities, should discuss their options with their tax advisor, including amending their prior year tax returns to reflect the income allocable to them from their IC DISCs, applying the principles as outlined in LR 2015-02.²⁹ Any changes to the income of an S Corporation will be taxed at the level of the S Corporation at a tax rate of 1.5 percent. A taxpayer that proactively amends its returns to apply this guidance may be better positioned should FTB enforcement efforts related to IC DISCs increase in connection with the ruling.

IC DISCs that paid amounts in excess of the California minimum tax (generally \$800) may want to consider filing a refund claim. Entities either organized under California law or registered with the California Secretary of State are subject to the California \$800 minimum tax.

²⁴ Although the FTB has identified that the sales or commission income attributed to an IC DISC used for federal tax purposes lacks economic substance, it should be noted that LR 2015-02 makes no mention of the imposition of a Noneconomic Substance Transaction Understatement penalty under Cal. Rev. & Tax. Code § 19774 of 40 percent of the amount of the understatement (reduced to 20 percent with adequate disclosure by means of a statement in the return).

²⁵ FTB Legal Ruling 2015-02, at 5.

²⁶ *Id.* at 5-6.

²⁷ *Id.*

²⁸ Cal. FTB Notice 2009-08 (Oct. 12, 2009), available [here](#).

²⁹ Note that any amended C Corporation return or S Corporation return for tax years beginning on or after January 1, 2010, where the understatement of tax exceeds the greater of \$1 million or 20 percent of the tax reported on the original return, is subject to a strict liability penalty of 20 percent of the entire amount of the understatement. See, Cal. Rev. & Tax. Code § 19138, (Large Corporate Income Tax Understatement Penalty). For tax years beginning on or after January 1, 2003, but before December 31, 2009, the LCUP applies to corporations with a tax understatement in excess of \$1 million.

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