

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 13-08**

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This ruling is based on the particular facts and circumstances presented, and is an interpretation of the law at a specific point in time. The law may have changed since this ruling was issued, possibly rendering it obsolete. The presentation of this ruling in a redacted form is provided solely for informational purposes, and is not intended as a statement of Departmental policy. Taxpayers should consult with a tax professional before relying on any aspect of this ruling.

SUBJECT

Whether compensation paid by an Interest Charge Domestic International Sales Corporation, in the form of a dividend for federal tax purposes, is deductible from net earnings for Tennessee excise tax purposes.

SCOPE

This letter ruling is an interpretation and application of the tax law as it relates to a specific set of existing facts furnished to the Department by the taxpayer. The rulings herein are binding upon the Department, and are applicable only to the individual taxpayer being addressed.

This letter ruling may be revoked or modified by the Commissioner at any time. Such revocation or modification shall be effective retroactively unless the following conditions are met, in which case the revocation shall be prospective only:

- (A) The taxpayer must not have misstated or omitted material facts involved in the transaction;
- (B) Facts that develop later must not be materially different from the facts upon which the ruling was based;
- (C) The applicable law must not have been changed or amended;
- (D) The ruling must have been issued originally with respect to a prospective or proposed transaction; and
- (E) The taxpayer directly involved must have acted in good faith in relying upon the ruling; and a retroactive revocation of the ruling must inure to the taxpayer's detriment.

FACTS

[TAXPAYER] (the "Taxpayer") is a Tennessee corporation. The Taxpayer requested and received approval by the Internal Revenue Service ("IRS") to be treated as an Interest Charge Domestic International Sales Corporation ("IC-DISC") for federal income tax purposes. The Taxpayer's two officers are each 50% shareholders of the corporation. Each officer has a compensation agreement with the Taxpayer, whereby their compensation for services rendered is

characterized for federal income tax purposes as a dividend, as required by the federal IC-DISC regulations.

RULING

Are the amounts distributed as a dividend to the Taxpayer's shareholders under their compensation agreements deductible from the Taxpayer's net earnings for Tennessee excise tax purposes?

Ruling: No. The amounts distributed as a dividend to the Taxpayer's shareholders are not deductible from net earnings for Tennessee excise tax purposes.

ANALYSIS

I. INTEREST CHARGE DOMESTIC INTERNATIONAL SALES CORPORATION

An Interest Charge Domestic International Sales Corporation ("IC-DISC") is a corporation formed to serve as an "export tax incentive that allows small and mid-sized exporters to drastically reduce the rate at which their income is taxed."¹ An IC-DISC is the modern day successor entity to the "foreign sales corporation," which came under attack by the European Union and World Trade Organization for being an unfair export subsidy. The IC-DISC is an entity capable of existing solely on paper, in that it does not need employees, office space, or tangible assets. The entity simply serves as a conduit to reduce the exporter's federal tax liability on export income.

IC-DISCs operate in the following manner: First, an exporter forms a corporation in one of the fifty states or the District of Columbia and makes an IC-DISC election with the IRS. After receiving IRS approval, the exporter pays the IC-DISC a "sales commission" in the amount of: 1) 4 percent of the company's gross receipts from qualified exports, or 2) 50 percent of its net income from qualified exports.² Finally, the exporter deducts the commission paid to the IC-DISC as an ordinary income tax deduction.³ The IC-DISC then distributes the commission by way of a dividend to the shareholders.

¹ 1 ALAN S. GUTTERMAN & ROBERT L. BROWN, GOING GLOBAL: A GUIDE TO BUILDING AN INTERNATIONAL BUSINESS § 20:36 (2012-2013 ed.).

²See generally I.R.C. § 992 (LexisNexis 2013). There are additional requirements to form an IC-DISC, including that the entity: 1) maintain a minimum capitalization of \$2,500; 2) have a single class of stock; and 3) meet a qualified export receipts test and a qualified export assets test. See also Internal Revenue Services, *IC-DISC Audit Guide*, IRS.GOV, <http://www.irs.gov/Businesses/International-Businesses/IC-DISC-Audit-Guide> (last visited June 14, 2013).

³ I.R.C. § 162(a)(1) (LexisNexis 2013).

IC-DISCs are governed by I.R.C. §§ 991-997 (LexisNexis 2013).⁴ I.R.C. § 991 (LexisNexis 2013) states that “a DISC shall not be subject to” the federal income tax. Shareholders of an IC-DISC, however, are “subject to taxation on the earnings and profits of a DISC as provided in this chapter [I.R.C. §§ 1-1563], but subject to the modifications” found in I.R.C. § 995 (LexisNexis 2013).⁵

The IC-DISC can either distribute the sales commission to its shareholders in the form of a dividend or retain it and defer paying tax. A “dividend,” for federal tax purposes, is defined as a distribution by a corporation to its shareholders “out of its earnings and profits accumulated after February 28, 1913” or “out of its earnings and profits of the taxable year.”⁶ Dividends are taxed at a 15 percent rate according to I.R.C. § 1 (LexisNexis 2013). This rate was increased to 20 percent by the American Taxpayer Relief Act of 2012 for those earning a taxable income of \$450,000 or above.⁷

An IC-DISC may defer distributing earnings and profits, resulting in a deferred tax liability.⁸ This deferral is limited to \$10 million dollars per year in earnings and profits, with any amounts above this threshold being a deemed dividend that becomes immediately taxable.⁹ I.R.C. § 995(f)(1) states that a “shareholder of a DISC shall pay for each taxable year interest in an amount equal to the product of – (A) the shareholder’s DISC-related deferred tax liability for such year, and (B) the base period T-bill rate.”

There are two major benefits bestowed by the IC-DISC election. First, as stated above, the exporter gets to deduct the commission as an ordinary income deduction. Second, for the IC-DISC shareholders, the commission income is treated as a dividend and is taxed at a favorable rate when distributed.¹⁰

As further discussed below, the IC-DISC forgoes its ability, however, to deduct the dividend as reasonable compensation from its taxable income for federal tax purposes.¹¹

⁴Although the Internal Revenue Code refers only to Domestic International Sales Corporations (“DISC”), the common appellation includes “Interest Charge” to reflect the fact that a DISC may defer up to \$10 million in tax liabilities for which it is charged interest.

⁵ I.R.C. § 995(a) (LexisNexis 2013).

⁶ I.R.C. § 316(a)(1)-(2) (LexisNexis 2013).

⁷ American Taxpayer Relief Act of 2012, H.R. 8, 112th Cong. (2012) (codified in relevant part at I.R.C. § 1(i)(3) (West, Westlaw current through P.L. 113-11 (excluding P.L. 113-4))).

⁸ I.R.C. § 995(f).

⁹ See I.R.C. § 995(b)(1)(E).

¹⁰ The Taxpayer therefore enjoys a significant tax reduction by making the election.

¹¹ See generally I.R.C. §§ 161-249 (LexisNexis 2013).

II. APPLICATION OF TENNESSEE LAW TO IC-DISCs

Tennessee imposes an excise tax at the rate of 6.5% on the net earnings of all persons, as defined under TENN. CODE ANN. § 67-4-2004(37) (Supp. 2012),¹² doing business in Tennessee.¹³ Tennessee also imposes a franchise tax at the rate of \$0.25 per \$100, or major fraction thereof, on the net worth of a person doing business in Tennessee, pursuant to TENN. CODE ANN. §§ 67-4-2105(a), -2106(a) (2011). Persons subject to Tennessee franchise and excise taxes include, but are not limited to, corporations.¹⁴

TENN. CODE ANN. § 67-4-2006(a)(1) (Supp. 2012) defines “net earnings” pertaining to “a corporation . . . or any other taxpayer required to file a federal income tax return on a federal form 1120 or any variation of that form . . . as federal taxable income or loss before the operating loss deduction and special deductions.”¹⁵ I.R.C. § 63(a) (LexisNexis 2013) defines “federal taxable income” as “gross income minus deductions allowed by this chapter [1].” One of the deductions enumerated in Chapter 1 is found in I.R.C. § 162(a)(1) (LexisNexis 2013), which provides that “a reasonable allowance for salaries or other compensation for personal services actually rendered” shall be deductible.

The Internal Revenue Code, however, does not provide a deduction for dividends paid to individual shareholders of an IC-DISC, even if the dividends are paid in lieu of a salary.¹⁶ Thus, the dividends paid by the IC-DISC to its shareholders are not deductible as compensation and consequently, are included in federal taxable income. It follows that IC-DISC dividends paid to shareholders and included in federal taxable income are also included in “net earnings” for purposes of the Tennessee franchise and excise tax.¹⁷

This result is illustrated by the computation of net earnings on the Tennessee franchise and excise tax return. The starting point for this Taxpayer, a corporation, when filing its Tennessee

¹² “Person” is defined by TENN. CODE ANN. § 67-4-2004(37) in pertinent part as including “every corporation.”

¹³ TENN. CODE ANN. § 67-4-2007(a) (2011).

¹⁴ See TENN. CODE ANN. § 67-4-2004(37) (Supp. 2012).

¹⁵ The special deductions are enumerated in I.R.C. §§ 241-247 (LexisNexis 2013). These special deductions are generally applicable in circumstances where triple taxation would occur. For example, I.R.C. § 243 allows a corporation to deduct a dividend received by another corporation. See also I.R.C. §§ 241-242, 244-247.

¹⁶ Dividends from a corporation to a shareholder are not enumerated among the deductible expenses in I.R.C. §§ 161-249 (LexisNexis 2013). Furthermore, the statutory regime regulating IC-DISCs does not specifically provide for the deduction of dividends from taxable income. Cf. I.R.C. §§ 561-565 (LexisNexis 2013) (specifically enumerating a deduction of dividends paid regarding Real Estate Investment Trusts).

¹⁷ Note that the Tennessee Code Annotated does not provide for a deduction from net earnings for dividends paid to individual shareholders, see generally TENN. CODE ANN. § 67-4-2006 (Supp. 2012), nor is an IC-DISC subject to an exemption, see generally TENN. CODE ANN. § 67-4-2008 (2011).

franchise and excise tax return is Schedule J-4,¹⁸ which is used to determine the net earnings for entities treated as corporations. Line 1 of Schedule J-4 asks for the amount reported on federal Form 1120, line 28. Form 1120, line 28, shows the “[t]axable income or loss before net operating loss deduction and special deductions.”

The Taxpayer, however, is required to file Form 1120-IC-DISC for federal income tax purposes, a variation of Form 1120. Form 1120 IC-DISC, line 5, captures essentially the same amount as line 28 on Form 1120; that is, “[t]axable income before net operating loss deduction and dividends-received deduction.”¹⁹ This line includes all deductions allowed on Form 1120 IC-DISC, Schedule E, which is entered on line 4. By entering the amount shown on Form 1120 IC-DISC, line 5, on Schedule J-4, line 1, the definition and application of “taxable income” and “net earnings” remain consistent among entities required to file Form 1120 or a variation thereof.

Therefore, since dividends are not deductible for federal tax purposes, nor are they deductible from net earnings for Tennessee excise tax purposes, the Taxpayer’s dividends to its shareholders must be included in its net earnings subject to Tennessee excise tax.

R. John Grubb II
Senior Tax Counsel

APPROVED: Richard H. Roberts
Commissioner of Revenue

DATE: July 11, 2013

¹⁸ Since the Taxpayer is a corporation required to complete a variation of federal Form 1120 (*i.e.*, Form 1120 IC-DISC), TENN. CODE ANN. § 2006(a)(1) dictates the starting point for completing its Tennessee franchise and excise return.

¹⁹ This line serves as the equivalent of line 28 on Form 1120. The dividends received deduction is one of the “special deductions” codified at I.R.C. § 243.