DEPARTMENT OF TAXATION
2014 Fiscal Impact Statement

1. Patron Ronald A. Villanueva

2. Bill Number HB 480

House of Origin:
_____ **Introduced**
_____ **Substitute**
_____ **Engrossed**

Second House:
__X__ **In Committee**
_____ **Substitute**
_____ **Enrolled**

3. Committee Senate Finance

4. Title Tax Exemption for Interest Charged-Domestic International Sales Corporations

5. Summary/Purpose:

This bill would exempt Interest Charged-Domestic International Sales Corporations ("IC-DISCs") from the corporate income tax, the minimum tax on telecommunications companies, and the tax imposed on electric suppliers, pipeline distribution companies, gas utilities, and gas suppliers.

This bill would be effective for taxable years beginning on or after January 1, 2014.

6. Budget amendment necessary: No.

7. Fiscal Impact Estimates are: Not available. (See Line 8.)

8. Fiscal implications:

Administrative Cost

The Department of Taxation ("the Department") considers implementation of this bill as routine, and does not require additional funding.

Fiscal Impact

This bill would have an unknown, but likely minimal, negative impact on General Fund revenues beginning in FY 2015. The number of IC-DISCs that are currently subject to taxation in Virginia is unknown. According to the IRS Statistics of Income, there were 773 active IC-DISCs in the United States in Taxable Year 1996. This number increased to 1,917 in Taxable Year 2008. It is unlikely many IC-DISCs are currently present in Virginia because they would be taxable under existing law. The number of Virginia IC-DISCs that may be created upon enactment of this bill is unknown.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

Tax Treatment of Exporters

In 1971, Congress began providing tax incentives for United States export companies to encourage them to manufacture goods in the United States. The first of these incentives allowed a United States company to use a Domestic International Sales Corporation ("DISC") to indefinitely defer the tax due on a portion of its export income. In this planning technique, a company would create a DISC, and transfer export income to the DISC by making commission payments to the DISC. The income paid to the DISC as commission payments was not subject to taxation until it was distributed to the DISC's shareholders as dividends.

Virginia did not conform to the federal tax exempt treatment of DISCs. For federal income tax purposes a DISC merely deferred a portion of the federal income tax for the period that amounts were kept in the DISC. The impact on Virginia was much more significant. Federal law required that 50 percent of the DISC's income be treated as a deemed distribution and taxed to the shareholder; the tax on the rest of the DISC's income could be deferred until actually distributed. However, both the deemed and actual distribution of DISC income would have been treated as dividends for Virginia purposes and would have been entirely exempt from income tax if 50 percent or more of the DISC was owned by the shareholder, which was usually the case.

To resolve this issue, the Department used its power to equitably adjust the tax imposed on certain related entities that are arranged in a manner that improperly reflects the business done or the Virginia taxable income earned from business done in Virginia to tax the income shifted to a DISC. This action was ultimately sustained by the Virginia Supreme Court in *Commonwealth of Virginia v. General Electric Company*, 236 Va. 54, 372 SE2d 599 (1988).

Due to concerns that the DISC incentive was a violation of the international General Agreement on Tariffs and Trade ("GATT"), Congress replaced DISCs with Foreign Sales Corporations ("FSCs") in 1985. A United States company that formed an FSC could receive a permanent federal tax exemption on a portion of export profits paid to an FSC as commission payments.

In 2000, the World Trade Organization ("WTO") found that the FSC incentive violated GATT, and it was replaced by the Extraterritorial Income Exclusion ("the ETI"). Unlike the DISC and FSC incentives, companies were not required to form a separate entity to exclude income using the ETI. Instead, any qualifying company could use this incentive to exclude a certain percentage of its export gross receipts or export income from taxable income.

Virginia conformed to the federal treatment of FSCs, and Virginia law still contains an exemption for FSCs and any income attributable to an FSC. However, because the federal FSC exemption was repealed, the Virginia exemption for FSCs is effectively dormant.

In 2002, the WTO found that the ETI was also a violation of GATT. As a result, Congress enacted the domestic production activities deduction in 2004 to replace this incentive by reducing the effective tax rate on domestic manufacturing. Companies may claim this deduction for engaging in qualified domestic production activities, including leasing, renting, selling, exchanging or other dispositions of qualified production property that was manufactured, produced, grown, or extracted in the United States; construction of real property performed in the United States; and engineering and architectural services performed in the United States. For Taxable Years 2005 and 2006, the deduction was equal to three percent of a company's qualified production activities or its taxable income, whichever was less. The amount of the deduction was increased to six percent for Taxable Years 2007, 2008, and 2009, and was increased to nine percent beginning in Taxable Year 2010.

Virginia fully conformed to the federal domestic activities production deduction through Taxable Year 2009. For Taxable Years 2010, 2011, and 2012, Virginia allowed taxpayers to continue claiming a six percent deduction, which was equal to two-thirds of the federal deduction. For these taxable years, taxpayers were required to add back thirty-three percent of the federal deduction on their Virginia returns. Effective for Taxable Years 2013 and thereafter, Virginia fully conforms to the nine percent federal domestic production deduction, and taxpayers are not required to make an adjustment to this deduction on their Virginia income tax returns.

<u>IC-DISCs</u>

When Congress replaced the DISC structure with FSCs in 1985, it also created the Interest Charged-Domestic International Sales Corporation ("IC-DISC") incentive. This offshoot of the original DISC incentive was intended for small and mid-size export companies, whereas the original DISC incentive was primarily used by large export companies.

An IC-DISC is a tax exempt entity that an export company may form as part of a planning technique to lower its federal rate of taxation on export income. In this planning technique, an export company forms a corporation that elects to be an IC-DISC. The export company then pays the IC-DISC commission payments for services provided. The amount of the commission payments may not exceed the greater of 50 percent of the export company's net export income or 4 percent of the export company's export sales revenue. The export company may claim a deduction from ordinary income for the amount of the commission payments.

The IC-DISC does not pay federal corporate income tax on the commission payments, as long as it is exempt from taxation. Such payments are not subject to taxation until the IC-DISC distributes the payments to its shareholders as dividends. However, the shareholders must pay annual interest on the deferred tax liability, hence the term "interest charged-DISC."

Once the dividends are distributed, the IC-DISC's shareholders will pay income tax on the dividends at the long-term capital gains rate for qualified dividends. Because the maximum federal long-term capital gains rate for qualified dividends is 20 percent and the maximum federal corporate income tax rate is 35 percent, the tax savings from using this planning technique may be 15 percent or more.

For federal tax purposes, an IC-DISC may only be exempt from taxation if:

- The IC-DISC is incorporated in one of the fifty states or in the District of Columbia;
- At least 95 percent of the IC-DISC's gross receipts during the taxable year are qualified export receipts;
- The adjusted basis of the IC-DISC's qualified export assets at the close of the taxable year equals or exceeds 95 percent of the sum of the adjusted basis of all assets of the corporation at the close of the taxable year;
- The IC-DISC does not have more than one class of stock and the par or stated value of its outstanding stock is at least $2,500 on each day of the taxable year; and
- The IC-DISC has made an election to be treated as an IC-DISC and such election is in effect for the taxable year.

An IC-DISC is required to file a federal information return (Form 1120-IC-DISC) if it elected (by filing federal Form 4876-A) to be treated as an IC-DISC and its election is in effect for the taxable year.

Virginia Income Tax Treatment of IC-DISCs

IC-DISCs are not currently exempt from taxation in Virginia, and must file and pay Virginia corporate income taxes even if they are exempt from federal taxation. Following the federal repeal of the traditional DISC structure, the Department published Public Document 88-153, which explained that the Department no longer needed to equitably adjust the tax imposed on DISCs, unless a taxpayer makes an election to be treated as an IC-DISC.

Although IC-DISCs are subject to Virginia income taxes, Virginia allows an income tax subtraction for dividends received upon the stock of certain IC-DISCs. For an IC-DISC shareholder to be eligible for the subtraction, 50 percent or more of the IC-DISC's income must be assessable for Virginia tax purposes for the preceding year, or the last year in which the IC-DISC has income.

Other States

Nineteen states (Alaska, Connecticut, Delaware, Florida, Georgia, Illinois, Indiana, Iowa, Kansas, Missouri, Montana, Nebraska, New Mexico, New York, Oregon, Rhode Island, South Carolina, Vermont, and West Virginia) either conform to the federal treatment of or provide preferential tax treatment for IC-DISCs. Many of these states have statutory or regulatory provisions expressly exempting IC-DISCs from state income taxation, while some states rely on their conformity to federal income tax law and administrative guidance to provide an income tax exemption.

In 2013, Oregon enacted legislation that exempted IC-DISCs from the minimum corporate tax and reduced the rate of taxation on any commissions received by the IC-DISC from a maximum rate of 9.9 percent to 2.5 percent. This legislation also provided a subtraction for any dividends received from an IC-DISC. The exemption and reduced rate of taxation apply only to IC-DISCs formed on or before January 1, 2014. The Oregon Legislative Revenue Office estimated that the IC-DISC provisions would have a combined negative General Fund revenue impact of $5 million during FY 2014 and FY 2015.

Four states (Nevada, South Dakota, Washington, and Wyoming) do not impose a corporate income tax and, therefore, do not tax IC-DISCs. The remaining 27 states (including Virginia) and the District of Columbia do not exempt IC-DISCs from taxation.

Proposed Legislation

This bill would exempt IC-DISCs and any income attributable to an IC-DISC for federal tax purposes from the corporate income tax, the minimum tax on telecommunications companies, and the tax imposed on electric suppliers, pipeline distribution companies, gas utilities, and gas suppliers that are subject to federal income taxation.

The effective date of this bill is not specified.

Similar Bills

Senate Bill 515 is identical to this bill.

cc : Secretary of Finance

Date: 2/4/2014 MTH
HB480FE161