North Carolina Department of Revenue

Roy Cooper
Governor

Ronald G. Penny
Secretary

March 8, 2023

[redacted]

Re: Request for Private Letter Ruling Regarding the Income Tax and Franchise Tax Treatment of a Controlled Foreign Corporation with Activity in North Carolina Due to a Single Member Limited Liability Company

Dear [redacted]:

This letter is a response to your letter dated April 4, 2022, wherein you requested on behalf of your client, [redacted], that the North Carolina Department of Revenue ("Department") provide a private letter ruling as to the proper methodology for calculating the franchise tax for one of Taxpayer's wholly-owned controlled foreign corporations ("CFCs").

The statement of facts submitted for the Department's consideration is as follows:

[redacted] ("Company") is a publicly traded corporation that holds interests in both 100% owned US incorporated entities and many 100% owned Controlled Foreign Corporations (i. e., entities treated as corporations that are organized in foreign countries). Several of the US corporations file in North Carolina and have for many years. In 2020, one of the CFCs, [redacted] ("CFC 1"), started to do business in North Carolina and other states through a disregarded single member limited liability taxpayer ("SMLLC"). This SMLLC is treated as a branch of CFC 1 for U.S. federal income tax purposes, as well as for North Carolina corporate income tax and franchise tax purposes. CFC 1 has nexus in North Carolina because of the activity of its SMLLC/branch, including ownership of inventory within North Carolina. The US branch owns inventory in every state. The US branch's sales of inventory go to a related corporation. These intercompany sales of inventory also occur in every state. The SMLLC also provides a service in the US.

CFC 1 not only has the new US branch, but it also has substantial operations outside of the US. Most of CFC 1's operations around the world are conducted through entities organized in various countries and treated as disregarded entities for US income tax purposes. For years prior to the creation of the US branch, Company had its CFCs manufacture inventory in Europe and China, and the inventory was sold to a US affiliate that then distributed the imported product to US customers. The imported inventory

produced by the CFCs was sold to the US affiliate to avoid giving a taxable presence to the CFCs in the US.

As a result of a tax law change contained within the Tax Cuts and Jobs Act (TCJA) enacted in December of 2017, Company decided to change how the imported product is sold in the US. As a result of the change in the TCJA, the legal and physical flow of inventory was changed.

The foreign manufactured inventory is now sold from CFC 1 to the SMLLC. This sale is disregarded for US income tax purposes because the sale is between a parent and a SMLLC that is disregarded for income tax purposes. The imported inventory are [redacted] devices that are used during surgeries by [redacted] surgeons. As a result of the need to have the inventory physically present in the hospital and surgical centers when the surgeries take place, the SMLLC owns the imported inventory in hospitals and surgical centers across the US. When an [redacted] surgeon selects the proper size [redacted] for a patient, a sale then takes place between the SMLLC and the US affiliate, and then a second sale takes place between the US affiliate and the third-party hospital/surgical center. As a result of this operational approach, the SMLLC has inventory in every state and has sales in every state when the [redacted] inventory is used by the [redacted] surgeons during surgeries. Since the SMLLC is disregarded, fictionally, CFC 1 is deemed to own the inventory in every state and is deemed to make the sales to the US affiliate.

The TCJA changed how Internal Revenue Code ("IRC") Section 863(b) is applied to a CFC. Previously, if a CFC owned inventory within the US and sold that inventory to a US customer, then the profits from the sale would be considered Effectively Connected Income (ECI), and thus would be subject to US federal income tax. The ECI from these US inventory sales would be part of the CFC's Federal Taxable Income ("FTI") on its US Form 1120-F. Because these types of transactions would create ECI for a CFC and subject the CFC to income tax in the US, most US corporations with CFCs would import inventory produced by a CFC and have it distributed / sold by a US affiliate. By importing the product to a US affiliate and by preventing the CFC from having any US operations, it would eliminate the creation of ECI for the CFC.

As referenced above, the change to IRC Section 863(b) that was part of the TCJA has substantially changed the ECI mechanism. One substantial change that occurred relates to imported inventory sales. The new IRC Section 863(b) no longer classifies profits from the sale of inventory from a CFC to US customers as ECI if the CFC both manufacturers the inventory and also physically sells the inventory in the US. The profits from the CFC's inventory sales to US customers that would have previously been ECI and reported in US FTI on its Form 1120-F are no longer ECI, and thus do not get reported within FTI on the CFC's Form 1120-F for tax years after 2017. The profits from the provision of services to US customers within the US by a CFC was ECI prior to the enactment of TCJA and continues to be classified as ECI after the enactment of TCJA. As a result of the change in IRC Section 863(b), CFC 1 formed a US branch in 2020, and the US branch now holds inventory in all 50 states for sale to customers and also provides services within the US.

RULING REQUESTED:

What is the proper franchise tax calculation methodology for CFC 1, taking into consideration the pertinent items below?

1. On CFC 1's North Carolina corporate income tax return, what is its "starting point"?

   Department's response: For North Carolina corporate income tax purposes, a corporate taxpayer is required to start with its federal taxable income since the computation of "state net income" begins with a taxpayer's federal taxable income.

   N.C. Gen. Stat. § 105-130.2(15) defines "state net income" as:

   > "The taxpayer's federal taxable income as determined under the Code, adjusted as provided in G.S. 105-130.5 and, in the case of a corporation that has income from business activity that is taxable both within and without this State, allocated and apportioned to this State as provided in G.S. 105-130.4."

   For CFC 1, its federal taxable income is reported on its IRS Form 1120-F. Since North Carolina has not decoupled from the changes made to IRC Section 863(b) made by the TCJA, the starting point for CFC 1 will be its ECI as calculated and reported on Form 1120-F pursuant to IRC Section 863. However, any sourcing modification pursuant to a comprehensive income tax treaty with the United States would not apply for North Carolina purposes.

2. What is CFC 1's sales factor for purposes of computing its income tax apportionment percentage?

   Department's response: For purposes of calculating the North Carolina sales factor, sales should include all gross receipts unless excluded according to N.C. Gen. Stat. § 105-130.4. Because CFC 1's sales of inventory are not considered when calculating ECI under IRC Section 863(b), the receipts derived from these sales should be excluded from the calculation of the sales factor pursuant to the aforementioned North Carolina statute.

3. What apportionment percentage is required to be used for purposes of apportioning a taxpayer's North Carolina franchise tax base?

   Department's response: Pursuant to N.C. Gen. Stat. § 105-122(c1)(1), a multistate corporation that is subject to the franchise tax must apportion its franchise net worth base utilizing the same apportionment percentage that it computed for corporate income tax purposes.

4. Should CFC 1 use its worldwide balance sheet or the balance sheet of its US branch for purposes of calculating its North Carolina franchise tax base?

Department's response: Since CFC 1 is a foreign entity that is filing a federal income tax return, it should only use the value of assets that are deemed to be based in the United States to compute its net worth base for North Carolina franchise tax purposes. [*See clarifying law change* in N.C. Gen. Stat. § 105-122(2b)]

This ruling answers the questions presented in the ruling request and does not address any other issues unrelated to the questions. It is based solely on the facts submitted to the Department of Revenue for consideration of the transactions described. Your statement of facts and our findings are subject to audit verification. If a taxpayer relies on this ruling and the Department discovers, upon examination, that the fact situation of the taxpayer is different in any material aspect from the facts and circumstances given in this ruling, then the ruling will not afford the taxpayer any protection. It should be noted that this document is not to be cited as precedent and that a change in statute, a regulation, or case law could void this ruling.

Should you have any questions, please contact me.

Very truly yours,

[redacted]

[redacted]
Corporate Tax Division
Telephone: (919) 814-1163
Fax: (919) 733-1821