Facing California's DISA Reporting Deadline of May 31, 2009 - Start Your Analysis Now

California unitary groups have until May 31, 2009, to report outstanding deferred intercompany stock account ('DISA') accounts for tax years 2001-2007. Understanding the DISA reporting requirements and identifying specific transactions that may have been a triggering event for California purposes is the first step to ensuring compliance with this reporting requirement. DISA accounts are similar to deferred intercompany transactions in stock in that they do not go away once created. When possible, it is best to avoid creating a DISA but if one is created it is important to carefully track it. The Franchise Tax Board has never formally enforced a reporting requirement, which has been in the regulations since 2001, so now they are attempting to get taxpayers to become compliant with a carrot and stick approach.

Franchise Tax Board's Notice 2009-01

On February 20, 2009, the California Franchise Tax Board (FTB) issued Notice 2009-01 reminding taxpayers of their obligation to annually disclose DISA transactions and account balances when filing their annual California corporation franchise or income tax returns. The notice highlights the FTB's authority, **in its sole discretion**, to require undisclosed DISA balances to be taken into income, in whole or in part, in any year that a taxpayer fails to comply with the disclosure requirements, even though no triggering event has otherwise occurred.

Additional tax liabilities and significant penalties

Taking a DISA balance into income could result in additional tax liabilities and significant penalties. With the 20 percent strict liability understatement penalty, which may be imposed in addition to other accuracy-related and underpayment penalties, the FTB's increased focus on DISA reporting takes on an even greater significance for California taxpayers.

How to approach the problem

Identifying and tracking a DISA is complex and a significant trap for California taxpayers due to circumstances that may result in different asset basis for federal and California income tax purposes. We recommend that taxpayers take a four step approach:

- Understand the federal excess loss account (ELA)
- Understand the DISA
- While appreciating the differences between an ELA and a DISA, review prior years' transactions, and make a good faith attempt to identify both the existence and amount of DISA balances
- Report the DISA balances on Form 3726

The first step: understanding a federal excess loss account (ELA)

A DISA is similar to the federal ELA in the consolidated return context, however, it differs in a number of respects and is unlikely to tie directly to the ELA. Most notably, as the name implies, a DISA is deferred income and not negative basis, so once it springs into existence it can't be reduced to zero, and thus it remains deferred income. Once a DISA exists it more closely resembles a deferred intercompany transaction in stock. Both DISAs and ELAs arise from IRC § 301(c)(3) distributions. These are distributions from one corporation to another in excess of earnings and profits (e.g. dividends) and basis.

The purpose of the federal ELA is to recapture in federal consolidated taxable income negative adjustments made to a subsidiary's stock to the extent such adjustments exceed the parent's basis (i.e., investment) in such stock. In essence the federal ELA represents negative stock basis. Accordingly, a federal ELA is created when a parent's basis in the stock of a subsidiary is reduced pursuant to Reg. sec. 1.1502-32 (and under other rules of law) by an amount greater than the parent's basis in the subsidiary's stock. Reg. sec. 1.1502-19(a)(2). For example, this may occur when a subsidiary borrows money and either incurs losses that are absorbed by the consolidated group or distributes the money to its parent corporation.

A federal ELA can be reduced or eliminated by positive basis adjustments for the subsidiary's taxable income or other positive basis adjustments under Reg. sec. 1.1502-32(b)(2), and by capital contributions from the parent corporation.

Generally, a federal ELA is taken into account as income or gain upon the disposition of subsidiary stock under Reg. sec. 1.1502-19(b). Thus, a federal ELA is generally triggered when the subsidiary stock is treated as disposed of. A parent corporation is generally treated as disposing of the stock of a subsidiary member when such stock is sold or becomes worthless, or upon the deconsolidation of the parent corporation or the subsidiary. Reg. sec. 1.1502-19(c).

Under the federal consolidated return rules, the liquidation of a subsidiary into another member of the consolidated group under Section 332 generally is not treated as a triggering event because the parent corporation's income or gain from a disposition of a subsidiary member is subject to

any nonrecognition rules applicable to the disposition. Reg. sec. 1.1502-19(b)(2)(i).

The second step: understanding California's Deferred Intercompany Stock Account (DISA)

The California statutes and regulations draw significant distinctions between distributions that are dividends and those that are not. Dividends between members of the same unitary combined reporting group that are paid from income that was included in a unitary combined report are eliminated for all tax purposes. However, prior to January 1, 2001, neither the statute nor the regulations addressed collateral tax consequences relating to other distributions between group members. Most notably, the statute and regulations did not address the potential to defer income recognized on non-dividend distributions in excess of basis. Based on the lack of guidance, the FTB asserted that distributions between group members were currently recognized rather than deferred, regardless of whether the members were unitary, unless expressly provided for to the contrary. *Safeway Stores, Inc. v. Franchise Tax Board*, 3 Cal. 3d 745, 478 P.2d 48 (1970); FTB Notice 97-2 (February 21, 1997). However, the FTB allowed taxpayers to defer recognition of non-dividend distributions if they entered into a closing agreement with the FTB that specified the terms of the deferral mechanism. FTB Notice 97-2 (February 21, 1997).

As of January 1, 2001, the FTB amended Cal. Code Regs., tit. 18 Sec. 25106.5-1 to allow taxpayers to establish a DISA solely for the purpose of deferring gain from non-dividend distributions in excess of a payor's earnings and profits and stock basis. A DISA is created when an intercompany distribution exceeds both the subsidiary's *California* earnings and profits and the parent's basis in the subsidiary stock. Cal. Code Regs., tit. 18 Sec. 25106.5-1(f)(1)(B). Note that these regulations are legislative regulations having the full force of a statute as the FTB was given statutory authority to issue them.

The regulation generally defines a DISA as an "accounting mechanism that a distributee corporation, which is a member of the combined group, will use to report and track non-dividend distributions in excess of its adjusted basis in the stock of the distributing subsidiary corporation, which is a member of the same combined reporting group, until this intercompany item is required to be taken into account pursuant to this regulation." The regulation provides that the balance of each DISA account must be disclosed annually on the taxpayer's return. Cal. Code Regs., tit. 18 Sec. 25106.5-1(b)(8).

Rather than adopt the entire federal ELA or federal investment adjustment scheme, the FTB made the DISA much narrower, operating solely for the purpose of tracking deferred items arising from intercompany distributions.

Although intercompany distributions are intercompany transactions (see Reg. sec. 1.1502-13(b)(1)(i)(D)), the investment adjustments are not intercompany transactions. California adopted only one small element of the investment adjustment scheme [i.e., deferral of Section 301(c)(3) gains] because the results for such distributions, in most cases, are consistent with the results expected under the intercompany transaction rules.

One of the FTB's primary concerns with the DISA was to make sure that taxpayers couldn't make income "disappear." Allowing the income to be deferred would be consistent with the unitary combined method of reporting, provided the parties were still in the group and the income could be triggered at some future date. Under the unitary theory, it would be proper to defer income until some event occurs, such as disaffiliation, the asset leaving the group, or a conversion of the asset to nonbusiness use. The role of the unitary business principle is to source, through apportionment, a taxpayer's 'net income' as defined under the Revenue and Taxation Code.

The unitary theory does not provide a justification to eliminate income that is subject to tax under the Revenue and Taxation Code. If the federal consolidated rules were adopted in total then such elimination would otherwise be available through a Section 332 liquidation or additional capital contributions. The FTB chose not to go so far when it proposed the DISA rules. Thus, while a DISA arises from ELA type transactions, once it exists it more closely resembles a deferred intercompany transaction in stock.

The third step: keep the federal and state differences in mind, and make a good faith effort to identify DISA transactions and balances

ELA's disappear and DISAs don't; while a federal ELA is eliminated permanently upon the tax-free liquidation of the subsidiary into the parent, or if the parent merges into the subsidiary, California requires that a DISA be recognized in the event of a tax-free liquidation or when the parent merges into the subsidiary. Because a parent's DISA is deferred income and not negative basis, the DISA is taken into account on liquidation. The deferred income, restored as a result of the liquidation, will be taken into account ratably over sixty (60) months unless the taxpayer elects to take the income into account in full in the year of liquidation. Cal. Code Regs. tit. 18 Sec. 25106.5-1(f)(1)(B)(2).

With respect to a review of prior transactions, there are two key federal and California differences as to why ELA balances will not tie to DISA balances:

- Unlike the federal rules, California does not tier-up subsidiary E&P. This may result in a material difference between the federal and California amounts of a subsidiary's E&P available for making a dividend versus non-dividend distribution.
- California also does not increase or decrease a subsidiary's stock basis for a lower-tier subsidiary's taxable income or loss. This difference potentially results in a material difference in the parent's federal and California amount of stock basis in the subsidiary, and thus whether or not a DISA is created upon receipt of a distribution.

Complex issues can also arise with regard to transfers of the entities within a combined group, tax-free mergers of the entities into another member of the combined group, and entity conversions, etc.

When developing a plan to identify distributions and transactions that may have led to a DISA, a review of federal ELA accounts will likely be a great starting point, yet further work will need to be done, including the review of material distributions that did not create ELAs, prior basis studies and federal or state transaction opinions. All prior ELA balances will need to be reviewed including those that have disappeared. Since the ability to accelerate a DISA is in the sole discretion of the FTB, we recommend that taxpayers use a good faith effort to identify the federal and state differences in both their existence and amount and report DISA balances. Neither the regulations nor the notice are clear on the disclosure standards that would avoid acceleration. For example, it is unclear whether DISA would be accelerated if one of many transactions was not disclosed or if the accounts were reported but the amounts were significantly inaccurate on one or more transactions, or some combination of the two.

The real challenge for taxpayers may be addressing situations where data limitations prevent them from determining with certainty whether a distribution created a DISA. On one hand, if they file a protective disclosure for a transaction when they are not sure a DISA was created, the DISA balance will have to be reported each year and triggering transactions will have to be avoided. On the other hand, if they are unable to confirm the creation or amount of a DISA and do not report it, there is a risk that the FTB will assert that a DISA exists and accelerate an estimated amount into income.

The fourth step - reporting the DISA balances

To facilitate the reporting of existing DISA accounts, the FTB issued Form 3726, DISA and Capital Gain Information. A complete Form 3726 must be attached to a taxpayer's originally filed Form 100 or Form 100W, California Corporation Franchise or Income Tax Return, for the 2008 taxable year and every year thereafter.

Recognizing that taxpayers may not have been compliant with this reporting requirement since the 2001 adoption date of the regulations, the FTB is allowing taxpayers to file Form 3726 for prior years where a disclosure should have been made without filing an amended return unless a prior triggering event has occurred that would have required the DISA to be taken into income during that prior year. The FTB advises that, if taxpayers satisfy their disclosure requirement for these prior years then the previously undisclosed balances will not be included in income due to their prior nondisclosures. Form 3726 must be filed with the FTB for these prior years on or before May 31, 2009 (please note that May 31, 2009, falls on a Sunday, so the actual filing deadline is June 1, 2009).

The notice states that, with respect to years 2001 through 2007, where a taxpayer has not yet fulfilled its disclosure obligation on an original return, the taxpayer may use Form 3726 to fulfil such obligation and eliminate the need to file an amended return, unless a prior triggering event has occurred. Per the notice, an amended return including a Form 3726 will be required where a prior triggering event has occurred that requires a taxpayer to take the relevant DISA balance into income.

Observation: The notice is ambiguous as to the reporting obligations with respect to closed tax years. As noted above, taxpayers should use Form 3726 in lieu of an amended return to remedy prior nondisclosures of DISA's that have not been triggered; however, an amended return will be required for open tax years where a triggering event has occurred in that tax year.

The following PricewaterhouseCoopers California specialists have significant experience with understanding the complex circumstances in which a DISA may arise and can assist with a review of prior years' transactions to ensure compliance with the May 31, 2009 filing deadline:

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