

California – Public hearing scheduled for DISA regulation

April 30, 2013

In brief

On July 25, 2013, the California Franchise Tax Board (FTB) will hold [a public hearing](#) regarding proposed modifications to California Code of Regulations (Reg.) section 25106.5-1, specifically pertaining to the treatment of deferred intercompany stock accounts (DISAs). Taxpayers interested in commenting on the proposed changes may provide written comments until 5:00 p.m. on July 25, 2013. [[Initial Statement of Reasons, Proposed Regulation 25106.5-1](#)]

In detail

Reg. section 25106.5-1(f)(1)(B) addresses the situation when a distributee corporation receives a non-dividend distribution in excess of its basis in the stock of the distributor corporation and both the distributee and distributor are members of the same combined reporting group.

California treats distributions in excess of basis differently than IRC section 301(c)(3), which generally uses the concept of an excess loss account (ELA) and provides that such intercompany distributions cause a negative basis in the stock.

For California purposes, the distribution in excess of basis is generally a capital gain. However, when both the distributee and distributor are in the same combined reporting

group, the distributee may defer the gain until such time as one of the entities leaves the reporting group. The deferred gain is maintained in a DISA, and must be reported annually on the California tax return (CA Form 3726). The DISA is recognized as income and is taken into account when a sale, liquidation, or any other disposition (not defined) of shares of stock occurs, or when one of the entities leaves the group. DISAs are generally taken into income over 60 months unless an election is made to bring them all into income immediately.

Proposed regulation amendments

Proposed changes include the:

- reduction of a DISA through merger with a brother/sister corporation with basis

- reduction of a DISA through subsequent capital contribution
- treatment of a distribution through various tiers of stock ownership.

The takeaway

DISAs have been a trap for the unwary in California for more than a decade. In the FTB's initial proposed changes, a DISA, once created, could not be reversed until triggered and recognized as income. The current proposed regulatory changes provide guidance regarding the elimination or reduction of a DISA due to merger, subsequent capital contributions, and distributions through tiered stock ownership.

The public hearing announcement marks the beginning of the formal California regulatory process. The FTB is required to hold at least one public hearing and address all public comments in writing before finalizing

the proposed changes. After the FTB addresses public comments and the three-member FTB approves, the regulation can then be finalized. Since the FTB previously held three Interested Parties Meetings regarding

these proposed amendments (the last meeting was held on August 16, 2011), we expect these amendments to proceed timely.

Let's talk

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