California – Amended regulation includes guidance for reducing DISAs, changes may be applied prospectively or retroactively

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In brief

Amended California Code of Regulations (Reg.) section 25106.5-1, regarding the treatment of Deferred Intercompany Stock Accounts (DISA), was approved by the Office of Administrative Law on January 8, 2014, and will become effective April 1, 2014. The changes provide guidance regarding the treatment of brother/sister mergers, distributions through ownership tiers, and DISA reduction through capital contributions. Taxpayers tracking and reporting DISAs should consider reviewing previously reported DISAs to reflect any changes caused by these revisions, such as a DISA reduction or elimination caused by subsequent capital contributions.

The new provisions are applicable to transactions occurring on or after January 1, 2001. However, a taxpayer may elect to have the changes apply prospectively starting April 1, 2014.

In detail

California treatment of intercompany distributions described by Internal Revenue Code (IRC) section 301(c)(1) is provided in Reg. section 25106.5-1(f)(1)(B). The California statute treats distributions in excess of basis differently than the federal treatment under Treasury Regulation section 1.1502-19, 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, a distribution in excess of current year earnings and profits, accumulated earnings and profits, and basis is generally a capital gain. However, when both the distributee and distributor are in the same combined reporting group, the gain is generally deferred until such time as one of the entities leaves the reporting group. The deferred gain is maintained in a DISA and attaches to the stock of the entity that made the distribution in excess of basis under IRC section 301(c)(3). A DISA must be reported annually on the California tax return using Form 3726. The DISA is recognized as income and is taken into account when a sale, liquidation, or any other disposition (not defined) of the shares of stock to which the DISA attaches occurs, or the gain no longer satisfies requirements to be deferred. Once triggered, a DISA is generally taken into income over 60 months unless an election is made to bring it all into income immediately.

The amended regulation addresses the following issues:

- Merger with a brother/sister corporation will not trigger a DISA; instead, the deferred amount will be spread proportionally to the stock in the surviving entity.
- Taxpayers can reduce DISAs by making subsequent capital contributions.
- Distributions through various tiers of stock ownership will no longer create multiple, separate DISAs.

Reg. Section 25106.5-1 applies to intercompany transactions occurring on or after January 1, 2001. However, a taxpayer may elect to have these DISA changes apply *prospectively* as of April 1, 2014.

The takeaway

DISAs have been a trap for the unwary in California for more than a decade. These regulatory changes can be beneficial as they provide a way to eliminate or reduce a DISA through capital contributions, and to prevent DISAs from being inadvertently triggered if a taxpayer merges with a brother/sister corporation. In addition, distributions moving through various tiers of stock ownership will not create multiple DISAs. Regardless of these changes, taxpayers will need to continue to track and report DISAs for California purposes. Taxpayers should consider looking at previously reported DISAs to reflect any changes caused by these revisions, such as a DISA reduction or elimination caused by subsequent capital contributions.

Let's talk

For more information on the California DISA regulation, please contact:

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