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Multistate Tax
EXTERNAL ALERT

California: DISA Rules - Proposed Changes to California's Regulation on Intercompany Transactions

Revised June 20, 2013

Overview

The Franchise Tax Board ("FTB") has issued a notice that a public hearing has been scheduled on July 25, 2013, to receive comments on proposed amendments to California Code of Regulations ("CCR"), title 18, section 25106.5-1 (hereinafter the "Intercompany Regulation").[1]

According to the FTB, the proposed amendments are necessary to update the Intercompany Regulation's conformity date to Treasury Regulation § 1.1502-13, reflect additional guidance with respect to the treatment of deferred intercompany stock accounts ("DISAs") and to provide further guidance regarding the proper apportionment treatment of intercompany transactions that are reported utilizing the simplifying rules of CCR 25106.5-1(e).[2] Also, according to the FTB, the proposed amendments to the Intercompany Regulation would be retroactive in application.[3]

If the FTB does not receive any comments at this public hearing or written comments before the 5pm deadline on July 25, 2013 that it believes support the need for additional amendments to this regulation, it will forward the regulation package as currently amended to the Office of Administrative Law ("OAL"). Assuming this scenario, the OAL could approve the proposed amendments in their current form in August 2013 and the amended regulation could become effective on October 1, 2013, and be retroactive in application.[4]

This Tax Alert summarizes key provisions of the Proposed Amendments to the Intercompany Regulation.

Summary of the Proposed Amendments

Conformity Date to Treasury Regulation Section 1.1502-13

Under the current version of the Intercompany Regulation, Treasury Regulation § 1.1502-13 is incorporated as amended through March 17, 1997, except as otherwise provided.[5] Under the proposed amendments, the conformity date would be revised to April 1, 2012.[6] According to the Statement of Reasons for the proposed Intercompany Regulation, the purpose for the proposed amendment is to ensure that California's Intercompany Regulation is based on the most current version of the applicable federal consolidated return rules.

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[1] *Notice of Hearing.* (https://www.ftb.ca.gov/law/hearings/NOH_07252013_25106_5_1.pdf).

[2] *Initial Statement of Reasons for the Amendment of California Code of Regulations, Title 18, Section 25106.5-1.* (https://www.ftb.ca.gov/law/hearings/ISR_07252013_25106_5_1.pdf).

[3] *See Notice of Hearing* at pg. 1.

[4] Effective January 1, 2013, regulations required to be filed with the California Secretary of State become effective on a quarterly basis such that a regulation filed between June 1 and August 31 would become effective on October 1. Cal. Gov't Code § 11343.4 (2013). Nevertheless, if the underlying regulation relates to a statute that was enacted prior to January 1, 1998, the FTB's position is that it may, at its discretion, prescribe that a regulation applies retroactively. See Cal. Gov't Code § 11343.4(b)(1) and Cal. Rev. & Tax. Code § 19503. The FTB has stated in the Notice of Public Hearing for the July 25, 2013, meeting (available at https://www.ftb.ca.gov/law/hearings/NOH_07252013_25106_5_1.pdf) that the amendments to CCR 25106.5-1 will be retroactive in application. The amendments would therefore apply to all transactions occurring on or after January 1, 2001, which is the original effective date of the regulation. CCR 25106.5-1(k).

[5] CCR, title 18, Section 25106.5-1(a)(2).

[6] *Proposed CCR Section 25106.5-1(a)(2).* (https://www.ftb.ca.gov/law/hearings/PR_07252013_25106_5_1.pdf).

Similar to Treasury Regulation § 1.1502-13, the Intercompany Regulation only applies to transactions between corporations which are members of the same combined reporting group immediately after such transactions occur. The term intercompany transaction does not include transactions which produce nonbusiness income or loss to the selling member, or income attributable to a separate business activity of the selling member.[7]

Proposed Regulation's Deferred Intercompany Stock Accounts ("DISAs") Relief Provisions

Under the current version of the Intercompany Regulation, a DISA is that portion of a distribution between corporate members of a unitary combined filing group which exceeds the distributor's California earnings and profits and the recipient's basis in the distributor's stock (the portion of a distribution described by Internal Revenue Code ("IRC") § 301(c)(3)).[8] A DISA is treated as deferred income, which is held by the recipient of the distribution. A DISA will be taken into account by the recipient as income or gain upon the sale, liquidation or any other disposition of the distributor's stock by the recipient. A disposition will be deemed to occur if the distributor's stock becomes worthless,[9] but a transfer of the distributor's stock by the recipient to another member of the combined group will not trigger the recognition of a DISA.[10]

Unlike an Excess Loss Account created for federal tax purposes under Treasury Regulation § 1.1502-19, a DISA may not be cured by a subsequent capital contribution or by stock basis adjustments under Treasury Regulation § 1.1502-32. After a DISA is created, any subsequent capital contribution will increase the recipient's stock basis in the distributor from zero, but not reduce the amount of the DISA held by the recipient. For example, P forms S by contributing $10 cash in Year 1. In Year 2, S borrows $20 from an unrelated party and distributes the $20 to P. S does not have any current or accumulated E&P in Year 2 such that $10 of the distribution is treated by IRC § 301(c)(2) as a return of capital with the remaining $10 distribution being treated by IRC § 301(c)(3) as creating a $10 DISA . In Year 3, P contributes $20 to S. In this example, P would have a $10 DISA and zero stock basis in S at the end of Year 2. At the end of Year 3, P would continue to have a $10 DISA, but would have $20 in stock basis in S.

Taxpayers who have created DISAs are required to disclose the DISA balance on their annual California tax return. Failure to disclose may result in income recognition of the undisclosed DISA amounts in accordance with CCR Section 25106.5-1(j)(7).

Proposed Amendments - Subsequent Capital Contributions

Under the proposed amendments, a DISA may be reduced by a subsequent capital contribution and any capital contribution in excess of the DISA amount will increase the recipient or P's stock basis in the distributor.[11] Taxpayers will still be required to report any reduced or eliminated DISAs as part of their annual disclosure.[12]

This is a significant change for taxpayers that already have a DISA. Since a DISA cannot currently be cured or reduced under the existing Intercompany Regulation, taxpayers that have a DISA should have evaluated whether the corresponding amount was a taxable temporary difference and recorded California deferred taxes. While deferred taxes are generally not provided for combined entities when the investment is expected to be recovered without recognizing taxable income related to any outside basis difference (an exception to the requirement to recognize deferred tax under ASC 740-30-25-7) that exception would not appear to be applicable to a DISA for the reasons noted above. If this proposed amendment is formally adopted, taxpayers should re-evaluate whether a DISA related deferred tax should be recognized for financial statement purposes.[13]

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[7] CCR 25106.5-1(b)(1)(B).
[8] CCR 25106.5-1(f)(1)(B).
[9] CCR 25106.5-1(f)(1)(B)1.
[10] The DISA would become a deferred intercompany item. CCR 25106.5-1(f)(1)(B)3.
[11] *Proposed CCR 25106.5-1(f)(1)(B)2.*
[12] *Proposed CCR 25106.5-1(j)(7).*
[13] It is not the purpose of this Tax Alert to opine, conclude or recommend how a California DISA should be treated for financial statement purposes. Such treatment is beyond the scope of this Tax Alert.

Proposed Amendments - Intercompany Transfers

Under the proposed amendments, a DISA may also be reduced if the stock to which the DISA balance relates is transferred to another member of the California combined reporting group that already possesses stock with a positive basis in the entity.[14] The DISA of the transferred stock may be reduced by the positive basis of the stock already owned by the transferee.[15]

Proposed Amendments - Intercompany Mergers

Currently, any sale, liquidation, or disposition of stock, which has a DISA attached to it, will cause the holder to recognize the DISA, unless the stock is transferred to another member of the combined group.[16] Thus, any merger or liquidation among intercompany members, who have stock with a DISA attached to it that will not survive such merger or liquidation, will trigger the recognition of a DISA even if the underlying assets of the merged or liquidated member have not left the California combined reporting group.

While the proposed amendments do not provide any change with respect to the treatment of liquidations, they do provide that a disposition of stock and the recognition of a DISA will not occur when members of a combined reporting group merge into one another, if the majority of the voting shares of the stock of each member are owned by other members of the combined reporting group.[17] Any DISAs related to the stock of the merged member will carry over to the stock of the surviving member even if the stock to which the original DISA relates to no longer exists.[18]

Proposed Amendments - Intercompany Tiered Distributions

Currently, California earnings and profits do not reflect intercompany items of income and losses until those items are recognized for tax purposes.[19] Thus, there is the potential to create multiple DISAs in a tiered distribution. For Example, P owns stock in S1 with a basis of $20 and S1 owns stock in S2 with a basis of $10. In Year 1, both S1 and S2 have accumulated and current E&P of $40. In Year 1, S2 distributes $100 to S1, who in turns distributes $100 to P. Under the current regulation, S1 would have a $40 dividend, $10 return of stock basis and a $50 DISA. P would have a $40 dividend (excluded from income), $20 return of stock basis, and a $40 DISA.

Under the proposed amendments, if a member distributes an amount of money or property to another member, who in turn thereafter distributes no more than the same amount of money or the same property to another member, any DISA arising from the initial distribution will be treated as earnings and profits for purposes of determining the DISA, if any, arising from the second distribution.[20] Going back to the example above, S1 would continue to have a $40 DISA, but P would have a $90 dividend and a $10 return of stock basis.

Clarification of Apportionment Treatment under the Simplifying Rules

Under the current version of the Intercompany Regulation, the simplifying rules of Treasury Regulation § 1.1502-13(e) are incorporated, unless otherwise provided.[21] Under the simplifying rules, if a taxpayer makes a federal election to treat intercompany transactions on a separate entity basis (e.g., to currently recognize the intercompany gain or loss on such transaction) the taxpayer will be treated as making a similar election for California purposes unless the taxpayer makes an affirmative election to the contrary. Because intercompany items of income and losses are recognized currently for tax purposes when treated on a separate entity basis under the election, some taxpayers may have taken the position that under the election, gross receipts related to these transactions should also be recognized and included in the sales factor of the apportionment formula (i.e., not treated as intercompany items).

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[14] *Proposed CCR 25106.5-1(f)(1)(B)4.*
[15] *Id.*
[16] CCR 25106.5-1(f)(1)(B) and (f)(1)(B)3.
[17] *Proposed CCR 25106.5-1(f)(1)(B)2.*
[18] *Id.*
[19] CCR 25106.5-1(j)(4).
[20] *Proposed CCR 25106.5-1(j)(4).*
[21] CCR 25106.5-1(e)(1).

Currently, the Intercompany Regulation provides that "sales attributable to intercompany items are not included in S's [selling member's] sales factor either in the year of the transaction or in the year(s) in which such intercompany items are taken into account."[22] The FTB has proposed additional language be added to this section of the Intercompany Regulation stating that the section applies "regardless of whether an election is made under subsection (e)(2) of this regulation to recognize income or loss from an intercompany transaction on a separate entity basis."[23] According to the FTB, these proposed amendments are being made as a clarification of the current rule and, as such, are capable of operating retroactively to years prior to the year in which the regulation amendments are formally adopted and approved.[24]

Considerations

If the proposed amendments are formally adopted and approved, taxpayers may want to consider the impact, if any, the amendments may have on any proposed or historical intercompany transactions, including any outstanding DISA balances. Additionally, taxpayers should also consider that the proposed amendments may also impact their U.S. GAAP financial reporting under ASC 740.[25]

Contacts

If you have questions regarding the proposed amendments to the Intercompany Regulation, or other California tax matters, please contact any of the following Deloitte Tax professionals.

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[22] CCR 25106.5-1(a)(5)(A)1.
[23] *Proposed CCR 25106.5-1(a)(5)(A)4.*
[24] *See Initial Statement of Reasons* at pg. 2.
[25] It is not the purpose of this Tax Alert to opine, conclude or recommend how a California DISA should be treated for financial statement purposes. Such treatment is beyond the scope of this Tax Alert.