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FTB Releases Guidance on Reporting DISA Transactions

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The California Franchise Tax Board (FTB) has issued FTB Notice 2009-01 (Feb. 20, 2009) (Notice) to "remind" taxpayers of their annual disclosure requirement regarding deferred intercompany stock account (DISA) transactions and the consequences of a failure to disclose. California Code of Regulations (CCR), title 18, section 25106.5-1 et seq., applicable for tax years beginning on or after January 1, 2001, requires a member of a California combined reporting group that is a distributee corporation to use a DISA mechanism 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 the intercompany item is required to be taken into account.

California Revenue and Taxation Code (CR&TC) section 24451 conforms California law to Internal Revenue Code sections 301 and 311 (distributions) and 312 (earnings and profits), which may give rise to non-dividend distributions that present DISA issues. CR&TC section 25106 provides for the elimination of intercompany dividends between members of a combined report to the extent they are paid out of earnings and profits (E&P) of the unitary business. (*See also Willamette Indus. v. Franchise Tax Bd.* (1995) 33 Cal. App. 4th 1242.) Once current and accumulated E&P have been depleted, additional (non-dividend) distributions will reduce the shareholder's basis in the stock. Distributions in excess of both E&P and the shareholder's basis in the stock are treated as a capital gain. CCR 25106.5-1(f)(1)(B) provides such a capital gain may be deferred, but must be tracked in a DISA. CCR 25106.5-1(b)(8) provides the balance of each DISA account must be disclosed annually on the taxpayer's return. That deferral continues indefinitely either until the recipient is no longer included in the combined report (i.e., excluded from the unitary group by a water's-edge election) or until the occurrence of some other triggering the event (i.e., the sale, liquidation, or any other disposition of shares of the stock). Income restored from a DISA transaction will be apportioned using the taxpayer's California apportionment percentages for the taxable year in which the income is restored.[1] (CCR 25106.5-1(f).)

The Notice announces that the FTB has now released a new form (Form 3726 (2008)) to disclose the annual requirements of each DISA balance and to report the capital gains from a DISA due to the occurrence of a triggering event.

CCR 25105.5-1(j)(7) provides that if a taxpayer fails to disclose its DISA balance on its annual tax return, the FTB may, in its discretion, require the amounts in the undisclosed DISA accounts to be taken into account in whole or in part in any year of such failure. The Notice warns that this could result in additional tax liability and imposition of various penalties, including the accuracy-related penalty under CR&TC section 19164 and the large corporate understatement penalty under CR&TC section 19138.

However, the Notice states that for years 2001 through 2007, taxpayers who have not yet fulfilled their disclosure obligation can fulfill that obligation by submitting a Form 3726 for each of those prior years, and an amended return need not be filed absent the existence of a triggering event in a prior year. If taxpayers satisfy their disclosure obligations as indicated in the Notice, the Notice states that previously undisclosed balances will not be included in income due to the prior nondisclosure. The Notice also states that taxpayers with any as yet undisclosed DISA balances for tax years 2001 through 2007 should submit a Form 3726 by May 31, 2009, for each year in which they have not met their disclosure requirement.[2]

Because no form was previously available for the required disclosure of each DISA balance on a taxpayer's return, disclosure in past years may have been minimal. In our experience, the FTB has not aggressively pursued non-disclosers in the past. However, with publication of this "reminder" and the new Form 3726, the FTB is positioned to monitor DISA disclosures more carefully going forward.

If you have any questions or would like further information on these developments, please contact: Eric Coffill, ECoffill@mofo.com; Tim Gustafson, TGustafson@mofo.com; Carley Roberts, CRoberts@mofo.com; Tom Steele, TSteele@mofo.com; or Andres Vallejo, AVallejo@mofo.com, of Morrison & Foerster's State and Local Tax group.

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[1] Special rules apply for "partially included water's-edge corporations." CCR 25106.5-1(j)(3).

[2] This May 31, 2009 submission date was not included in the Notice when it was originally published on February 20, 2009. According to the FTB's website, on February 25, 2009, the FTB "revised" the Notice and added this due date language to Notice 2009-1, but did not change the "02.20.09" date shown on the Notice.