STATE OF CALIFORNIA
FRANCHISE TAX BOARD
Legal Division MS A260
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07.30.2025

Legal Ruling – 2025-01

SUBJECT: Allocation of basis resulting from Internal Revenue Code[1] (IRC) section 355 transaction, when a Deferred Intercompany Stock Account (DISA) balance is attributable to distributed stock.

ISSUE

If there is a DISA attributable to stock, what effect will a distribution of that stock in the nonrecognition transaction described below have on the DISA and the basis in the stock?

SITUATION

Top Corporation (Top Tier), the distributing corporation, will engage in a transaction (Transaction), in which Top Tier distributes stock in Bottom Corporation (Bottom Tier), the controlled corporation, to Top Tier's shareholders. No person owns a 50-percent or greater interest in Top Tier.

<u>Before the Transaction.</u>

Before the Transaction, Top Tier owns all the outstanding stock of Middle Tier Corporation (Middle Tier Tier). Middle Tier owns all the outstanding stock of Bottom Tier. Top Tier, Middle Tier, and Bottom Tier are members of the same combined reporting group (Top Tier CRG).

Top Tier has a basis in the Middle Tier stock of $200. The Middle Tier stock has a fair market value (FMV) of $100, exclusive of the FMV of Bottom Tier stock.

In a prior tax year, Bottom Tier made a non-dividend distribution to Middle Tier in excess of Middle Tier's basis, at the time of distribution, in Bottom Tier stock, in the amount of $100. Middle Tier reported and tracked this non-dividend distribution in a DISA in the manner described in California Code of Regulations, title 18 (CCR), section 25106.5-1, subd. (b)(8). As a result, Middle Tier has a zero basis in the Bottom Tier stock and a $100 DISA balance attributable to the Bottom Tier stock. The Bottom Tier stock has an FMV of $100.

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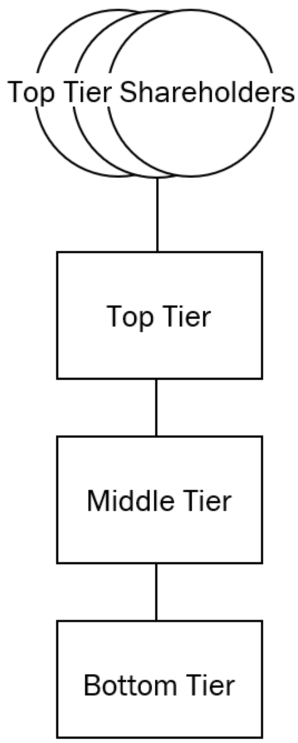
[1] All references to the Internal Revenue Code herein refer to the Internal Revenue Code as that term is defined in California Revenue and Taxation Code (RTC) sections 17024.5 and 23051.5, unless otherwise provided.

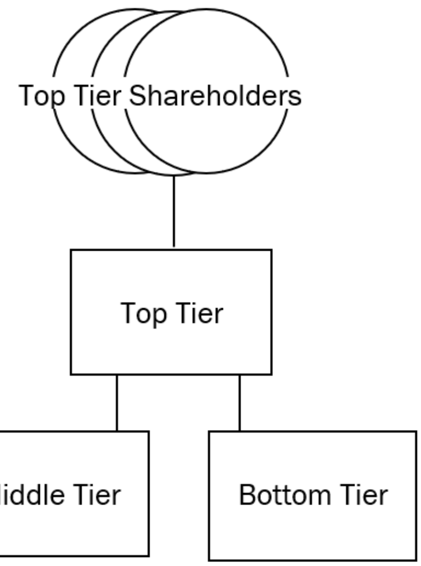
<u>The Transaction</u>

First, Middle Tier will distribute (First Distribution) its Bottom Tier stock to Top Tier.

Before First Distribution

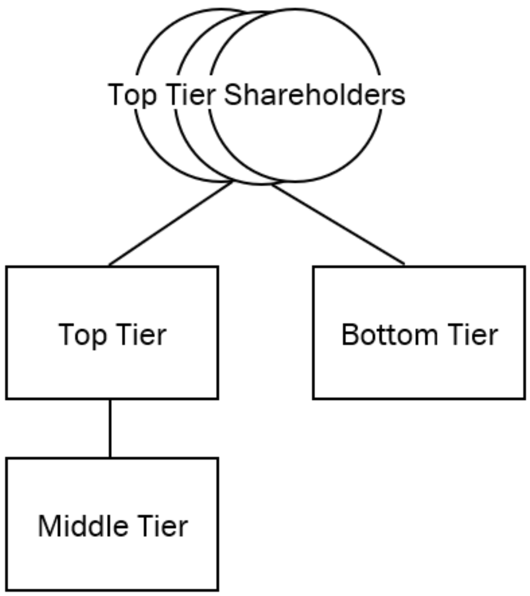


After First Distribution



Then, Top Tier will distribute (Second Distribution) the Bottom Tier stock to its shareholders.

After Second Distribution



For purpose of this ruling, any applicable requirements for nonrecognition under IRC section 355 are assumed to have been satisfied.[2] Likewise, the Top Tier CRG is assumed to have properly reported and tracked the DISA and disclosed the balance of the DISA on its annual returns, as required by CCR section 25106.5-1, subd. (b)(8).

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[2] For example, IRC section 355(a)(1)(A) requires that the distributions are solely stock or securities of a corporation that the distributing corporation controls immediately before the distribution; IRC section 355(a)(1)(B) requires that the transactions are not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both; IRC section 355(a)(1)(C) requires that the active business requirements are satisfied; IRC section 355(a)(1)(D) requires that the distributing corporation distributes all of the stock and securities of the subsidiary or an amount constituting control within the meaning of IRC section 368(c) (but only if it is established to the satisfaction of the Secretary that the retention by the distributing corporation of stock, or stock and securities in the controlled corporation was not in pursuance of a plan having one of its principal purposes the avoidance of Federal income tax); Treasury Regulation (Treas. Reg.) section 1.355-2(b) requires that the independent business purpose requirement is satisfied; and Treas. Reg. section 1.355-2(c) requires that there is a continuity of interest by the individuals or entities that owned, either directly or indirectly, the business or businesses prior to the distribution. (*See, S. Tulsa Pathology Lab. v. Commissioner* (2002) 118 T.C. 84, 91-92 (describing the four statutory requirements under IRC § 355(a)(1) and the two regulatory requirements under Treas. Reg. § 1.355-2(b) and (c).)

LAW & ANALYSIS

Under IRC section 355, distributions of stock and securities that meet certain requirements do not result in the recognition of income.[3] In a qualifying transaction, a distributing corporation distributes a controlled corporation's stock to the distributing corporation's shareholders. The distributing corporation no longer owns the controlled corporation stock.

DISA

DISAs are accounting mechanisms to track non-dividend distributions in excess of basis. A DISA is required to be tracked as an intercompany item until it is taken into account pursuant to CCR section 25106.5-1.

CCR section 25106.5-1 generally provides rules for taking into account items of income, gain, deduction, and loss from intercompany transactions within combined reporting groups.[4] For this purpose, CCR section 25106.5-1, subd. (b)(1)(A), defines an "intercompany transaction" as follows:

> [T]he term “intercompany transaction” means a transaction between corporations which are members of the same combined reporting group immediately after such transaction.

CCR section 25106.5-1 identifies the member that is the seller as "S" and the member that is the buyer as "B".[5] The regulation also defines the term "intercompany item" under CCR section 25106.5-1, subd. (b)(3), as "S's income, gain, deduction, and loss from an intercompany transaction[.]"[6]

The term DISA is defined in CCR section 25106.5-1, subd. (b)(8), which provides that:

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[3] RTC section 24451 incorporates Subchapter C of Chapter 1 of Subtitle A of the IRC, except as otherwise provided. Generally, California conforms to the IRC as enacted on January 1, 2015. (RTC §§ 17024.5, subd. (a)(1)(P), 23051.5, subd. (a)(1).) Under RTC section 24462, California conforms to IRC section 355, as of January 1, 2010. Pursuant to RTC sections 17024.5, subd. (d) and 23051.5, subd. (d), federal regulations promulgated under IRC sections that California conforms to generally apply for California purposes.

[4] *See* CCR section 25106.5-1, subd. (a)(1) (explaining the purpose of CCR section 25106.5-1).

[5] *Ibid*. The regulation also refers to a parent corporation as P. *See* CCR § 25106.5-1, subd. (c)(2).

[6] Intercompany item corresponds to "corresponding item" which is defined in CCR section 25106.5-1, subd. (b)(4), as B's income, gain, deduction, and loss from an intercompany transaction.

> DISA is the accounting mechanism that a distributee corporation, which is a member of the combined reporting 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 balance of each DISA account must be disclosed annually on the taxpayer's return.

CCR section 25106.5-1, subd. (f)(1)(B), further explains DISAs:

> That portion of an intercompany distribution which exceeds California earnings and profits and P's basis in S's stock (the portion of a distribution described by section 301(c)(3) of the Internal Revenue Code) will create a DISA. In this subsection, [S's parent corporation, "P"] is treated like the Buyer (B) for purposes of calculating corresponding and recomputed items.
>
> The DISA will be treated as deferred income. To the extent of a sale, liquidation, redemption or any other disposition of shares of the stock, the balance of the DISA with respect to such shares will be taken into account as income or gain to P even if S and P remain members of the same combined reporting group. The disposition shall be treated as a sale or exchange for purposes of determining the character of the DISA income or gain. The DISA is held by the distributee.

Following subdivision (f)(1)(B), CCR section 25106.5-1 lists additional rules for DISAs. One of these rules, CCR section 25106.5-1, subd. (f)(1)(B)4., provides that:

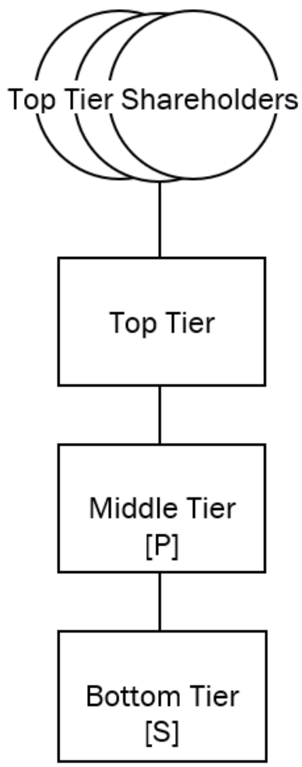
> If P transfers the stock of S to another member of the combined reporting group, P's DISA income will be an intercompany item and deferred under the rules of this regulation. If the other transferee member of the combined reporting group to whom P transfers the S stock already possesses S stock with a positive basis, any outstanding DISA attributable to the shares transferred by P will be reduced by the basis in the stock already possessed by the other member of the combined reporting group.

Prior to the First Distribution, Bottom Tier made a non-dividend distribution to Middle Tier, in excess of Middle Tier's basis in Bottom Tier stock and the income was deferred.[7]

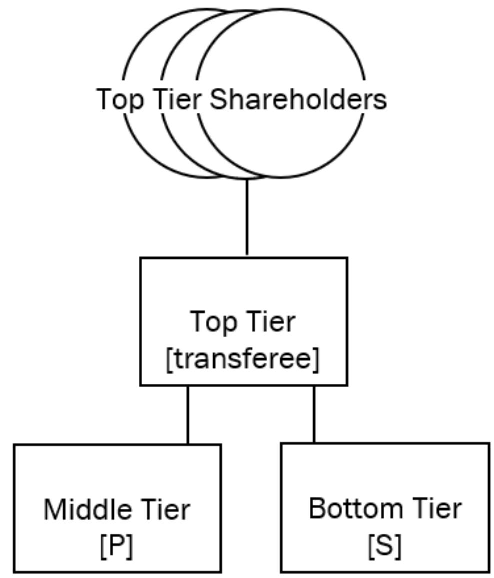
In the First Distribution, Middle Tier distributes the Bottom Tier shares to Top Tier.[8] Top Tier, Bottom Tier, and Middle Tier are all in the same combined reporting group (i.e., Top Tier CRG). As Middle Tier (P) transferred Bottom Tier (S) stock to Top Tier, Middle Tier's (P's) DISA income will continue to be an intercompany item and deferred under CCR section 25106.5-1. Additionally, Top Tier, for purposes of CCR section 25106.5-1, subd. (f)(1)(B)4. is considered a transferee, because Middle Tier (P) transferred the Bottom Tier (S) stock to Top Tier.

Please see the diagram below, which includes the identifiers used in CCR section 25106.5-1:

Before First Distribution



After First Distribution



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[7] Accordingly, in terms of the identifiers used by CCR section 25106.5-1, subd. (f)(1)(B), Middle Tier is P and Bottom Tier is S; there is a DISA with respect to the Bottom Tier shares held by Middle Tier.

[8] In terms of the identifiers used in CCR section 25106.5-1, subd. (f)(1)(B)4., Bottom Tier is S and Middle Tier is P.

Under CCR section 25106.5-1, subd. (f)(1)(B)4., it is necessary to determine the effect of the First Distribution under Subchapter C of the IRC on Top Tier's ownership of Bottom Tier stock.

California conformity to IRC section 355

IRC section 355 generally provides that a distribution meeting certain requirements results in nonrecognition.[9] The first requirement, listed in IRC section 355(a)(1)(A), is that:

> (A) a corporation (referred to in this section as the "distributing corporation")—
>
> > (i) distributes to a shareholder, with respect to its stock, or
> >
> > (ii) distributes to a security holder, in exchange for its securities,
>
> solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution[.]

Thus, IRC section 355 involves a distribution of stock of a controlled corporation, distributed, with respect to stock ownership of the distributing corporation, to the shareholders of the distributing corporation (or in the case of a corporate shareholder, distributee corporation).

If all the requirements in IRC section 355(a)(1) are met (as well as any applicable regulatory requirements), "then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder [or distributee corporation] . . . on the receipt of such stock[.]"[10] This means that IRC section 355(a)(1) provides nonrecognition for the distributee corporation.

In addition, IRC section 355(c)(1) provides nonrecognition for the distributing corporation. IRC section 355(c)(1) states that, "[e]xcept as provided in paragraph (2), no gain or loss shall be recognized to a corporation on any distribution to which this section [. . .] applies and which is not in pursuance of a plan of reorganization."[11]

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[9] As noted above, under RTC section 24462, California conforms to IRC section 355as of January 1, 2010. The federal regulations interpreting that IRC section generally apply for California purposes. (RTC sections 17024.5, subd. (d) and 23051.5, subd. (d).)

[10] See, IRC section 355(a)(1) and footnote 3, above.

[11] IRC section 355(c)(2) provides that nonrecognition only applies to qualified property. IRC section 355(c)(2)(B) identifies qualified property as "stock or securities in the controlled corporation."

IRC section 358 applies to exchanges under IRC section 355 and prescribes rules for determining the basis of property received without recognition of income.[12] IRC section 358(a)(1) provides that, subject to the modifications in IRC section 358(a)(1)(A)-(B), property received in an exchange to which IRC section 355 applies has the same basis as "the property exchanged."

For IRC section 355 distributions, IRC section 358(c) states the distribution "shall be treated as an exchange, and for such purposes the stock and securities of the distributing corporation which are retained shall be treated as surrendered, and received back, in the exchange."

IRC section 358(b)(1) states that, "[u]nder regulations prescribed by the Secretary, the basis determined under subsection (a)(1) shall be allocated among the properties permitted to be received without the recognition of gain or loss." IRC section 358(b) further provides that, for exchanges under IRC section 355, the basis is allocated by the distributee corporation between (1) the distributing corporation stock that is retained and (2) the controlled corporation stock that is transferred without the recognition of gain or loss.

Treas. Reg. section 1.358-2(a)(2)(iv) provides, in pertinent part, that:

> If a shareholder or security holder receives one or more shares of stock or one or more securities in a distribution under the terms of section 355 (or so much of section 356 as relates to section 355), the basis of each share of stock or security of the distributing corporation (as defined in §1.355-1(b)), as adjusted under §1.358-1, shall be allocated between the share of stock or security of the distributing corporation with respect to which the distribution is made and the share or shares of stock or security or securities (or allocable portions thereof) received with respect to the share of stock or security of the distributing corporation in proportion to their fair market values. . . .

Thus, Treas. Reg. section 1.358-2(a)(2)(iv) provides that the distributee corporation allocates the basis in distributing corporation stock between (1) the distributing corporation stock and (2) the controlled corporation stock, based on FMV.

It is assumed that the Transaction, including each intermediate step, meets the requirements for nonrecognition in IRC section 355. Also, as noted above, in the First Distribution, Middle Tier distributes Bottom Tier stock to Top Tier (leaving Top Tier as owning both Middle Tier and Bottom Tier stock).

Under IRC section 355(a), Middle Tier, because it distributes Bottom Tier stock, is the distributing corporation, and Bottom Tier, because Bottom Tier stock was distributed, is the

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[12] As noted above, RTC section 24451 incorporates Subchapter C of Chapter 1 of Subtitle A of the IRC, except as otherwise provided, which includes IRC section 358.

controlled corporation. Because Middle Tier (the distributing corporation) distributed the stock to Top Tier, Top Tier is the distributee corporation.

Pursuant to IRC section 355(a)(1), Top Tier receives the Bottom Tier stock without recognition of gain or loss. Accordingly, the Bottom Tier stock is treated as property received without recognition of gain or loss for purposes of IRC section 358.

IRC section 358(a)(1) assigns a basis to property received without recognition of gain or loss equal to that of the property exchanged. Pursuant to IRC section 358(b)(2), as the First Distribution is a distribution to which IRC section 355 applies, the First Distribution is treated as an exchange for purposes of IRC section 358. IRC section 358(c) further provides that Top Tier's retained Middle Tier stock is treated as surrendered and received back in the exchange. Consequently, IRC section 358(a)(1) assigns a basis as though Top Tier exchanged its Middle Tier stock for (the same) Middle Tier stock and the Bottom Tier stock.

IRC section 358(b)(1) provides that the Treasury Regulations allocate the basis among the properties permitted to be received without the recognition of gain or loss. Thus, the Treasury Regulations promulgated under IRC section 358 allocate the basis among (1) the Middle Tier stock and (2) the Bottom Tier stock.

Specifically, Treas. Reg. section 1.358-2(a)(2)(iv) applies to stock received in a distribution under IRC section 355. Treas. Reg. section 1.358-2(a)(2)(iv) provides that the basis of each share of distributing corporation stock shall be allocated between the stock of the distributing corporation and the stock received, by FMV. Again, Middle Tier is the distributing corporation and Bottom Tier stock is received.

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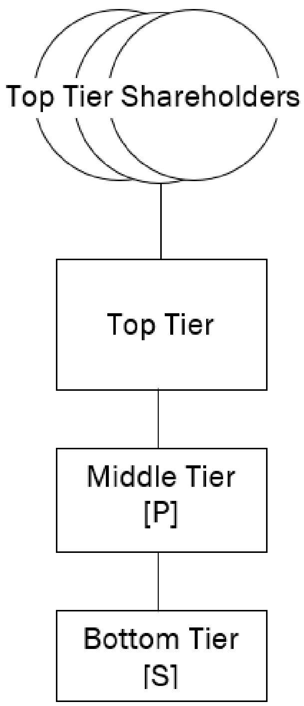
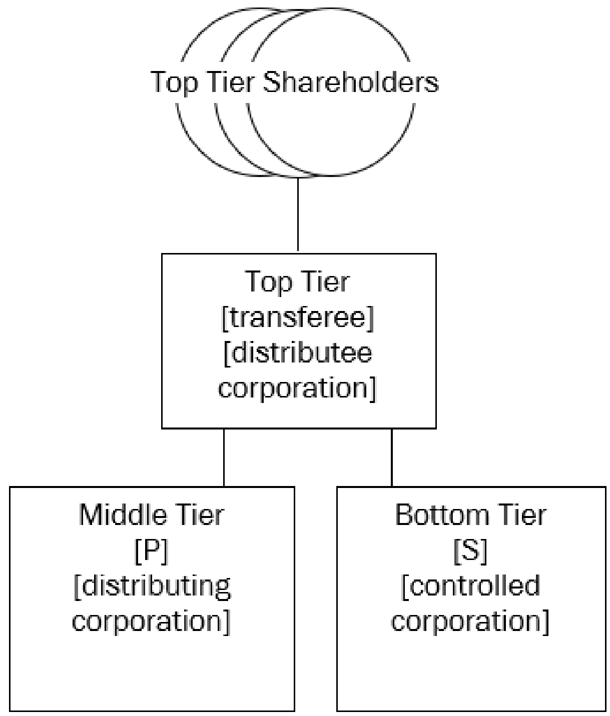
Please see the diagram below, which includes the identifiers used in CCR section 25106.5-1, IRC sections 355 and 358, and Treas. Reg. 1.358-2:

Before First Distribution



After First Distribution



Reduction of DISA

CCR section 25106.5-1, subd. (f)(1)(B)4. provides that:

> If P transfers the stock of S to another member of the combined reporting group, P's DISA income will be an intercompany item and deferred under the rules of this regulation. If the other transferee member of the combined reporting group to whom P transfers the S stock already possesses S stock with a positive basis, any outstanding DISA attributable to the shares transferred by P will be reduced by the basis in the stock already possessed by the other member of the combined reporting group.

Under CCR section 25106.5-1, subd. (f)(1)(B)4.,[13] Top Tier is the "other transferee member" and "the other member of the combined reporting group." Middle Tier is P and Bottom Tier is S.

CCR section 25106.5-1, subd. (f)(1)(B)4. requires that the other transferee member already possesses S stock with a positive basis for the independent clause to take effect. Thus, for there to be nonrecognition, Top Tier as the other transferee member would need to “already possess” Bottom Tier stock, which is the S stock, with a positive basis.

As noted, it is presumed that the First Distribution met the requirements for nonrecognition under IRC section 355. One such requirement is the continuity of interest requirement under Treas. Reg. section 1.355-2(c)(1).[14] Under IRC section 355 and Treas. Reg. section 1.355-2, Top Tier directly owned both Middle Tier (distributing corporation) and Bottom Tier (controlled corporation). The transfer of Bottom Tier stock to Top Tier "effects only a readjustment of continuing interest" in Middle Tier and Bottom Tier. (Treas. Reg. § 1.355-2(c)(1).) Moreover, Top Tier's shareholders continue to indirectly own Bottom Tier.

As previously noted, IRC section 358(a)(1) provides that the basis of property permitted to be received under IRC section 355 without the recognition of gain or loss shall be the same as that of the property exchanged. Top Tier is permitted to receive the Bottom Tier stock without recognition of gain.[15] Under IRC section 358(b)(1) and Treas. Reg. section 1.358-2(a)(2)(iv), Top Tier allocates basis between Middle Tier stock (as distributing corporation stock) and Bottom Tier stock (as stock received by Top Tier).

For purposes of CCR section 25106.5-1, subd. (f)(1)(B)4., because the continuity of interest requirement is satisfied, and the transfer is only a readjustment of this continuing interest, Top Tier is treated as already possessing the Bottom Tier stock. Moreover, Top Tier's shareholders continue to indirectly own Bottom Tier. The allocation of basis between the Middle Tier stock and Bottom Tier stock results in Top Tier having a positive basis in Bottom Tier stock. Accordingly, the First Distribution satisfies CCR section 25106.5-1, subd. (f)(1)(B)4.

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[13] CCR section 25106.5-1, subd. (f)(1)(B)4. ("If the other transferee member of the combined reporting group to whom P transfers the S stock already possesses S stock with a positive basis, any outstanding DISA attributable to the shares transferred by P will be reduced by the basis in the stock already possessed by the other member of the combined reporting group.").

[14] Treas. Reg. section 1.355-2(c)(1) ("Section 355 applies to a separation that effects only a readjustment of continuing interests in the property of the distributing and controlled corporations. In this regard section 355 requires that one or more persons who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange own, in the aggregate, an amount of stock establishing a continuity of interest in each of the modified corporate forms in which the enterprise is conducted after the separation. This continuity of interest requirement is independent of the other requirements under section 355.").

[15] IRC section 355(a)(1).

As a result, the outstanding DISA attributed to shares transferred by P must be reduced by the basis in the stock already possessed by the other member. The outstanding DISA is attributed to the Bottom Tier shares. The Bottom Tier shares are transferred by Middle Tier (P). Top Tier is the other transferee member. Thus, the outstanding DISA attributed to the Bottom Tier stock must be reduced by the basis allocated to Bottom Tier stock as a result of the First Distribution.

Consequently, the balance of DISA attributable to Bottom Tier stock will be reduced by Top Tier's positive basis in Bottom Tier stock.

HOLDING

Immediately after the First Distribution, where Middle Tier transfers its Bottom Tier stock to Top Tier, Top Tier allocates its basis in Middle Tier stock ($200) between Middle Tier stock and Bottom Tier stock by FMV.[16] As both Middle Tier stock and Bottom Tier stock have an FMV of $100, the basis of $200 is evenly divided between them, resulting in a basis of $100 for each.

For purposes of CCR section 25106.5-1, subd. (f)(1)(B)4., Top Tier will have a "positive basis" of $100 in Bottom Tier stock which it "already possesses."

Under CCR section 25106.5-1, subd. (f)(1)(B)4. Top Tier will apply existing basis in Bottom Tier to reduce to the DISA. The DISA balance ($100) is reduced by Top Tier's basis in Bottom Tier ($100). As result, after the First Distribution, the DISA balance will be zero and the DISA will be eliminated. Top Tier will have a basis of zero in the Bottom Tier stock.

In the Second Distribution, Top Tier distributes its Bottom Tier stock to Top Tier's shareholders. As the DISA was reduced to zero, transferring the Bottom Tier stock to Top Tier's shareholders did not result in any income to either Top Tier or Middle Tier.

DRAFTING INFORMATION

The principal author of this legal ruling is Brian L. Beck of the Franchise Tax Board, Legal Division. For further information regarding this ruling, contact Mr. Beck at the Franchise Tax Board, Legal Division, P.O. Box 1720, Rancho Cordova, California 95741-1720.

[16] Treas. Reg. section 1.358-2(a)(2)(iv).