



MULTISTATE INCOME/FRANCHISE TAX

California FTB issues guidance on deferred intercompany stock accounts

Tax Alert

Overview

On July 30, 2025, the California Franchise Tax Board (“FTB”) issued [Legal Ruling 2025-1](#) (“Ruling”), providing important guidance on the treatment of Deferred Intercompany Stock Accounts (“DISAs”) in the context of nonrecognition transactions under Internal Revenue Code (“IRC”) section 355. This development is particularly relevant for taxpayers that are members of a California combined reporting group (“CRG”) and engage in intercompany stock transfers.

This Tax Alert summarizes some of the guidance in the Ruling.

Background

Federal background

When a corporation makes a distribution in respect of its stock to its shareholders, the distribution is generally regarded as a dividend to the extent of the distributing corporation’s current and accumulated earnings and profits (“E&P”). Any further distribution is treated as a return of the shareholder’s basis in the distributing corporation’s stock to the extent thereof. Lastly, to the extent the distribution exceeds the shareholder’s basis, it is treated as gain from the sale of stock.

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 (in the case of a corporate shareholder, the distributee corporation) without recognition of gain or loss, provided certain requirements are met. These requirements include, among others, that the transaction is not used principally as a device for distributing earnings and profits, and that both the distributing and controlled corporations are engaged in an active trade or business immediately after the distribution.

For IRC section 355 distributions, IRC section 358 provides rules for determining a shareholder's basis in the property received and for allocating such basis among the items of property received. 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. IRC section 358(b)(2) further provides that when allocating basis, "there shall be taken into account not only the property so permitted to be received without the recognition of gain or loss, but also the stock or securities (if any) of the distributing corporation which are retained, and the allocation of basis shall be made among all such properties provides rules."

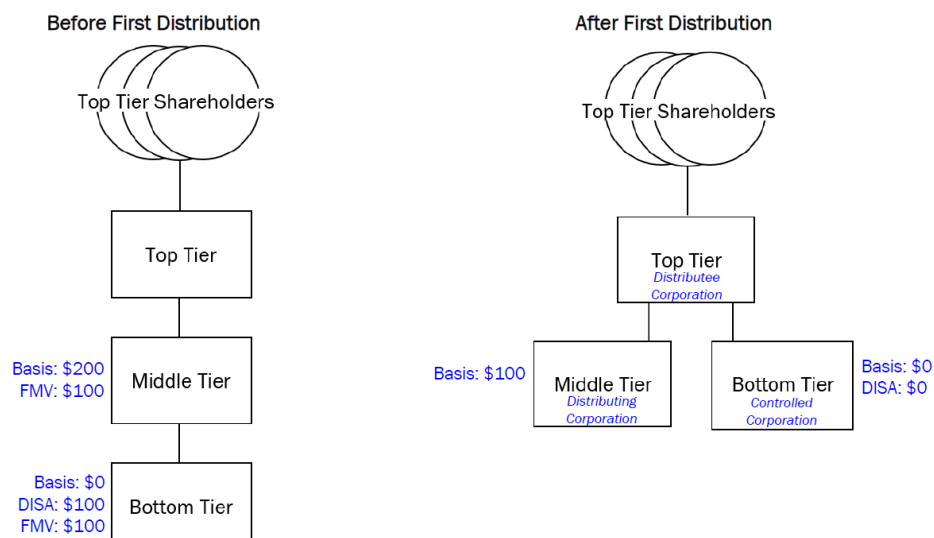
California background

For California corporation income tax purposes, when the distribution is from one member to another member of the same CRG, the gain is deferred. This deferred gain is reported and tracked in a DISA. The deferred gain reflected in the DISA is ultimately recognized upon a future triggering event, such as a sale, liquidation, redemption, or any other disposition of the shares of stock to which the DISA relates; even if both the distributing and distributee corporations remain as members of the same CRG.

California conforms to IRC sections 355 and 358, as both were in effect on January 1, 2015.

Illustrative scenario

The Ruling addresses how a DISA balance is affected when stock to which a DISA relates is distributed through a qualifying IRC section 355 nonrecognition transaction.



The Ruling provides the above diagram and corresponding example where, as part of an IRC section 355 non-recognition transaction, Middle Corporation (Middle Tier) distributes the stock of Bottom Corporation (Bottom Tier) to Top Corporation (Top Tier), and Top Tier then distributes the stock of Bottom Tier to its shareholders who are not part of the CRG.

Prior to these transactions, Middle Tier had a \$100 DISA balance in respect of its Bottom Tier stock on account it having received a prior non-dividend distribution from Bottom Tier in excess of Middle Tier's basis in Bottom Tier stock. However, because of California's conformity to IRC section 358, when Middle Tier distributes its Bottom Tier stock to Top Tier, Top Tier is required to determine its basis in the Bottom Tier stock received.

The FTB's Ruling states that under IRC section 358 and the Treasury Regulations promulgated thereunder, in the case of an IRC section 355 transaction, Top Tier's basis in Middle Tier stock immediately prior to the distribution must be allocated between its Middle Tier stock and its Bottom Tier stock, based on their relative fair market values ("FMVs").

Accordingly, when Middle Tier initially distributes its Bottom Tier stock having a FMV of \$100 to Top Tier, Top Tier will hold both its Middle Tier stock, having a FMV of \$100 (independent of the Bottom Tier stock it held), and the Bottom Tier stock, having a FMV of \$100. Top Tier must allocate its \$200 basis in Middle Tier between Middle Tier and Bottom Tier, based on their relative FMVs. This allocation reduces Top Tier's basis in Middle Tier from \$200 to \$100. Top Tier takes zero-dollar basis in Bottom Tier, as the \$100 of its basis reallocated from Middle Tier to Bottom Tier reduces dollar-for-dollar the \$100 DISA that existed immediately before Middle Tier distributed the Bottom Tier stock. When Top Tier subsequently distributes the Bottom Tier stock to its shareholders, there will be no DISA balance in respect of the Bottom Tier stock, and as a result, there will be no deferred gain required to be recognized.

Holding and key takeaways from Legal Ruling 2025-1

- Nonrecognition treatment: The FTB clarified that when a member corporation's stock, with an associated DISA, is transferred in a nonrecognition transaction under IRC section 355, the deferred income in the DISA is not recognized solely as a result of the distribution if the stock remains within the CRG.
- DISA attributable to stock: If there is a DISA attributable to stock, the distribution of that stock in an IRC section 355 transaction results in the distributing corporation allocating its basis between the distributing corporation and controlled corporation based on their relative FMV. The basis allocated to the controlled corporation stock will reduce dollar-for-dollar the DISA balance with respect thereto.
- Recordkeeping and compliance: DISAs are required to be tracked as an intercompany item until taken into account in a manner described under California Code of Regulations (CCR) 25106.5-1. The balance of each DISA must be disclosed annually on a California tax return. 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 any year of such failure. See CCR 25106.5-1(j)(7).

Taxpayers with questions about the application of Legal Ruling 2025-1 or the mechanics of DISA in the context of IRC section 355 transactions should consult with their tax advisors to ensure compliance with California's combined reporting requirements and to assess the impact on their specific facts and circumstances.

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