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Memorandum

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to: Associate Area Counsel
(Large & Mid-Size Business)

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subject: California Franchise Tax

This Chief Counsel Advice responds to your request for assistance dated June 1, 2005, regarding the accrual of the deduction for California Franchise Tax by commencing corporations. This advice is not taxpayer specific. This advice may not be used or cited as precedent.

ISSUES

(1) What is the amount of California Franchise Tax that a corporation using an accrual method of accounting and commencing business in California with a 12 month initial taxable year can deduct under § 164 of the Internal Revenue Code in the year of commencement, and in the following year?

(2) WHAT IS THE AMOUNT OF TAX THAT A CORPORATION USING AN ACCRUAL METHOD OF ACCOUNTING AND COMMENCING BUSINESS IN CALIFORNIA WITH AN INITIAL TAXABLE YEAR OF LESS THAN 12 MONTHS CAN DEDUCT UNDER § 164 IN THE YEAR OF COMMENCEMENT, AND IN THE FOLLOWING YEAR?

CONCLUSIONS

(1) A corporation using an accrual method of accounting and commencing business in California with a 12 month initial taxable year may deduct the amount of California Franchise Tax incurred during that year under the general principals of § 1.461-1(a)(2) of the Income Tax Regulations. For the second taxable year, § 461(d) requires that the taxpayer defer any amount that would otherwise be allowed under § 164, but exceeds the California Franchise Tax from the first year, since under pre-1961 California law taxpayers with a full first year measured the second year's tax by the first year's income. This treatment, limiting the deduction to the prior year's California Franchise Tax, will continue each year for as long as the corporation is subject to the California Franchise Tax.

(2) A corporation using an accrual method and commencing business in California with an initial taxable year of less than 12 months, may deduct the amount of California Franchise Tax incurred during that year under the general principals of § 1.461-1(a)(2). For the second taxable year, the corporation may also deduct the amount that is incurred under § 1.461-1(a)(2). However, for the third taxable year, § 461(d) requires that the taxpayer defer any amount that would otherwise be allowed under § 164, but exceeds the California Franchise Tax from the second year, since under pre-1961 California law taxpayers with a short first year measured the third year's tax by the second year's income. This treatment, limiting the deduction to the prior year's California Franchise Tax, will continue each year for as long as the corporation is subject to the California Franchise Tax.

FACTS

A corporation that employs an accrual method of accounting and reports income on a calendar year basis for federal income tax purposes commenced business in California in 1997 and is subject the California Franchise Tax (CFT). In 1997, the corporation incurred CFT of $1000 under general principals of federal tax accounting. In the following year, 1998, the taxpayer incurred $2000 of CFT. The facts are unclear as to whether the corporation is treated as having a year of commencement of 12 months, or less than 12 months.

LAW AND ANALYSIS

Section 164 allows a deduction for certain taxes, including the CFT in the year in which paid or accrued. When the tax is accrued is governed by § 461. Section 1.461-1(a)(2)(i) provides, in part, that under an accrual method of accounting, a liability is incurred, and generally is taken into account, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. A liability to pay a tax may become fixed before the tax is assessed, and before the tax is due. United States v. Anderson, 269 U.S. 424, 441 (1926).

Economic performance occurs for tax liabilities as the tax is paid, however, the recurring item exception is generally available and allows taxpayers to treat economic performance as occurring in the year that the all-events test is otherwise met as long as the tax is paid within 8½ months after the close of the taxable year. See, §§ 1.461-4(g)(6)(i), and 1.461-5.

An exception to the general rule of the all-events test is contained in § 461(d), which provides that to the extent that the time for accruing taxes has been accelerated by the action of any taxing jurisdiction taken after December 31, 1960, then such taxes shall be treated as accruing at the time they would have accrued but for such action by such taxing jurisdiction. Further, if a tax is accelerated, § 461(d) applies not only to taxpayers upon whom the tax is imposed at the time of the action, but also with respect to such taxpayers upon whom the tax is imposed at any subsequent time. Section 1.461-1(d)(1).

The accrual date of the California Franchise Tax has been accelerated by changes in California law that occurred after the effective date of § 461(d), December 31, 1960. See Rev. Rul. 79-410, 1979-2 C.B. 213, amplified by Rev. Rul. 2003-90, 2003-2 C.B. 353. When § 461(d) was enacted, the CFT was imposed upon the privilege of conducting business in the California taxable year (the privilege year), and was generally measured by the income from the previous year which was called the "income year." Peculiarly, the CFT was not imposed upon income generated during a corporation's final year of doing business in California. California Revenue and Taxation Code (Cal. Rev. & Tax Code), § 23332(a). Therefore, the Tax Court held that the liability for the CFT was not fixed by the earning of income in the income year, but rather by the exercise of the corporate franchise in the following year, the privilege year. Central Investment Corp. v. Commissioner, 9 T.C. 128 (1947), aff'd per curiam 167 F.2d 1000 (9th Cir. 1948).

Changes to California law effective for years after 1972 made a corporation's final year's income subject to the CFT. See for example, Cal. Rev. & Tax Code §§ 23151.1(d) and 23332(b). These changes caused the liability for the CFT to become fixed in the year the income is earned pursuant to § 1.461-1(a)(2), since exercising the corporation's franchise in the following year was no longer necessary in order to be liable for tax upon that income. However, this was an acceleration of the accrual date of the CFT that must be disregarded for federal income tax purposes under § 461(d). Epoch Food Service, Inc., 72 T.C. 1051 (1979); Rev. Rul. 79-410.

Additional changes in 1972 affected the treatment of commencing corporations. Special treatment for commencing corporations was necessary because a commencing corporation had no prior "income year" upon which to measure the tax. Before 1972, Cal. Rev. & Tax Code, § 23222(a) provided that commencing corporations were required to pay CFT on the income earned in the first year, with a credit for the minimum tax which was required to be prepaid.

If the corporation's first year consisted of 12 months, this amount was also used to measure the tax due for the second year. Thus, a corporation with a full first year treated the first year as the "income year" with respect to both the first and second taxable or privilege years.

A corporation with a first year consisting of less than 12 months used the short year's income as the basis of taxation for the first privilege year, and as the basis for calculating a pre-payment of the second year's franchise tax. The second year's CFT would ultimately be calculated using the second year's income, allowing a credit for the pre-payment based on the short year's income. Cal. Rev. & Tax Code § 23222(a); cf., Filoli, Inc. v. Johnson, 51 P. 2d 1093 (Cal. 1935) (wherein a corporation that commenced business on July 1, 1930, paid CFT on the short year's income for the first taxable year, and also used the short year's income as the basis for the second year's (1931) tax, but challenged additional tax assessed based on a statutory change to the precursor of Cal. Rev. & Tax Code § 23222(a) in 1931 that imposed additional tax for the second year by prorating the short year's income to 12 months). Under pre-1961 California law, even if the second taxable year of a commencing taxpayer constituted a period of less than 12 months, the tax for the second year was measured by the income earned during the second year. Cal. Rev. & Tax Code § 23222a. The second year also served as the "income year" with respect to the third year, so the third year's CFT was also measured by the second year's income. Cal. Rev. & Tax Code § 23222(a).

For years between 1972 and 2000, no distinction was drawn between full or short years of commencement; both were subject to only the minimum tax for their first California taxable year. Cal. Rev. & Tax Code, § 23151.1(a). The first year did, however, serve as the "income year" for the second year and the first year's income was the basis of the tax for the second year. Section § 23151.1(b) of the Cal. Rev. & Tax Code, specifically provided that a corporation which commenced and ceased doing business in the same year was subject to the CFT on that year's income.

In 2000, California law was changed to remove the concept of the "income year," and references to it were replaced with the phrase "taxable year" throughout the statute. This change in law clarified that the CFT is now imposed upon income as it is earned, but did not affect the timing of the deduction under the all-events test as applied to the 1972 changes, and did not alter the application of § 461(d). Rev. Rul. 2003-90. After these changes, commencing corporations are no longer subject to special treatment, and none is needed since the commencing corporation's lack of a prior "income year" no longer affects the determination of the tax due under the general provisions of the CFT. See, Cal. Rev. & Tax Code, § 23151.1(c)(2).

In Charles Schwab Corp. v. Commissioner, 107 T.C. 282 (1996), aff'd 161 F.3d 1231 (9th Cir. 1998), cert. denied 528 U.S. 822 (1999), (Schwab I) the Tax Court addressed the accrual of the California franchise tax for the second year of a corporation whose first year was a short year. The court acknowledged that in general the California franchise tax has been accelerated and is subject to § 461(d).

The court noted, however, that its prior decisions in Central Investment Corp., 9 T.C. 128; and Epoch Food Service, Inc., 72 T.C. 1051, did not address the special rules contained in Cal. Rev. & Tax. Code § 23222(a), for a commencing corporation with a short year of commencement. The court concluded that pursuant to this section the second year served as the "income year" for both the second and third privilege years, therefore even under pre-1961 law, the liability to pay franchise tax with respect to that income was incurred during the second year, when it was earned. The court indicated that the Service's reliance on Rev. Rul. 79-410 failed to account for the difference in treatment of a commencing corporation with a short first year under pre-1961 law, a circumstance which the revenue ruling did not address. In a subsequent proceeding addressing the accrual of Schwab's third year's CFT, the Tax Court held that the tax for the third year was also measured by the second year's income. Charles Schwab Corp. v. Commissioner, 123 T.C. 306 (2004) (Schwab III).

The First Year

Under the facts described the corporation commenced business in 1997. For the 1997 California taxable year the corporation's franchise tax liability was only the minimum tax as provided by Cal. Rev. & Tax Code, § 23151.1(a). However, the income generated in 1997 would provided the basis for the CFT for the 1998 California taxable year, whether or not the corporation continued in business and exercised its franchise in the following year. Therefore, the CFT liability that resulted from this income was fixed and determinable by the end of the 1997 federal tax year. Presumably economic performance occurred in that year as well, either by virtue of estimated tax payments in the year the income is earned, or upon remittance of the tax with the return in the following year under the recurring item exception.

Since the corporation would incur tax on its current income under the general principals of § 1.461-1(a)(2) applied to the post-1972 CFT, but would generally not have incurred tax until the franchise was exercised in the following year under the pre-1961 CFT, § 461(d) requires that the pre-1961 California law be used to determine when the deduction is incurred for federal income tax purposes. Under pre-1961 California law, Cal. Rev. & Tax Code, § 23222(a), provided that a commencing corporation's first year's tax was measured by its first year's income. Thus, even under pre-1961 California law, the liability for CFT was fixed in the year that the income was earned. There has been no acceleration, and therefore § 461(d) does not operate to defer the deduction for the first year. The corporation was entitled to the accrue the liability for $1000 of CFT imposed on the 1997 income in the 1997 federal taxable year, the year in which the income was earned, even though it relates to the 1998 California taxable year, and even if it was not assessed until 1998. This is so whether 1997 was a full year, or a short year.

The Second Year

In the following year, 1998, the corporation earned net income subject to the CFT, which created a CFT liability of $2000. Under the California law applicable between 1972 and 2000, this 1998 income was used to measure the CFT for the 1999 California taxable year. This 1999 CFT ($2000) was incurred for federal income tax purposes under the general principals of §1.461-1(a)(2), in the year that the income subject to the tax was earned, 1998. Since the corporation would incur franchise tax on its current income under the general principals of § 1.461-1(a)(2), but would generally not have incurred tax until the franchise was exercised under the pre-1961 CFT, § 461(d) requires that the pre-1961 California law be used to determine when the deduction was incurred for federal income tax purposes.

If the corporation conducted business for 12 months in the year of commencement, pre-1961 California law would use the income generated in that first year as the basis for measuring the franchise tax for the second year without regard to the income that was actually earned in the second year. Cal. Rev. & Tax Code, § 23222(a). In this situation, § 461(d) would require that the corporation deduct the CFT that was measured by the 1997 income ($1000), rather than the CFT based on the 1998 income ($2000), on its 1998 federal income tax return. The $2000 of CFT based on the 1998 income, would be deductible on the 1999 federal tax return, assuming that at least that amount of CFT was incurred during the taxpayer's 1999 federal taxable year. For all subsequent years, the corporation will continue to apply the principals of § 461(d) in determining the year of deduction of the taxpayer's CFT liability.

If the corporation commenced business in California with an initial taxable year of less than 12 months, pre-1961 California law would ultimately measure the second year's franchise tax by the second year's income. See, Cal. Rev. & Tax Code, § 23222(a). Therefore, even under pre-1961 California law, the CFT would have been incurred in the year that the income was earned. See, Schwab I, 107 T.C. 282. The treatment of the second and third years in this situation is similar to how the first and second years are treated when the first year is 12 months, as described above. The corporation may deduct the $2000 of CFT otherwise incurred in 1998 on its 1998 federal income tax return. But for the third year, the corporation's deduction is limited by § 461(d) to the $2000 of CFT from the second year. See, Schwab III, 123 T.C. 306. For all subsequent years, § 461(d) will continue to apply, limiting the deduction to the prior years California Franchise Tax liability. Rev. Rul. 2003-90.

Section 461(d) is a timing provision, and application of a method of accounting in compliance with § 461(d) should not result in a distortion of the taxpayer's lifetime income. See, § 1.446-1T(e). Nor can the application of § 461(d) allow a deduction under § 164(a) that exceeds the sum of the amount of CFT incurred in the current year and the cumulative amount of CFT deferred in prior years by § 461(d). As long as the amount of CFT incurred is increasing each year, the taxpayer need only look to the prior year's CFT to determine the amount of the deduction. However, § 461(d) does not provide authority to deduct an expense that has not yet been incurred under § 164(a) and § 1.461-1(a)(2). If any amounts deferred remain, or if excess deductions have been taken, final adjustments may be necessary in the year the corporation dissolves or withdraws from doing business in California. See § 1.461-1(d)(4); see also, Knight-Ridder Newspapers, Inc., v. U.S., 743 F.2d 781 (11th Cir. 1984).

Please call or if you have any further questions.