

CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 267

September 17, 1964

INSTALLMENT METHOD: UNREPORTED INSTALLMENT INCOME UPON WITHDRAWAL

Syllabus:

The taxpayer commenced to do business in this State in 1957. It was engaged in retail sales. Its returns were filed on the basis of a calendar year, and it elected to report the income from installment sales on the installment method provided in Section 24667 of the Revenue and Taxation Code.

Timely returns were filed for calendar years 1957 and 1958. The year 1958 is the taxpayer's first 12-month year. So that under Section 23222 the income of that year constitutes the measure of tax for both the taxable years 1958 and 1959. The taxpayer ceased doing business in the State in 1959 and withdrew its qualification to do business in 1959. Pursuant to Section 24672, the income from installment sales not reported prior to 1959 must be included in the measure of the tax for the year 1959.

(1) Is the amount of unreported installment income as of December 31, 1958, includible in the measure of tax for the taxable year 1958?

(2) When including in the year 1958, the income from installment sales made in the year 1957 and collected in 1958, is the allocation percentage to be applied the percentage computed for the year 1957 or the percentage computed for the year 1958?

(3) If a corporation has distributed or sold all of its assets except its installment obligations, upon which there is unreported income and which also bear interest, has the corporation "ceased business" within the meaning of Section 24672?

(1) Since the year 1958, if the first taxable year constituting a period of 12 months, the taxpayer must pay a tax for the taxable year 1958 based upon its net income for that year, and the return for the year 1958 is also the basis for the tax for the taxable year 1959. (Section 23222.) In addition, since the taxpayer ceased to be subject to the tax in the year 1959, the income from installment sales that had not been reported prior to the year 1959 must be included in the measure of tax for the year 1959. (Section 24672.) Thus, the unreported installment income as of December 31, 1958, is added to the net income for the year 1958 to produce the measure of tax for the taxable year 1959. However, since the net income of the year 1958 is also the measure of tax for the taxable year 1958, the question is raised whether adding the unreported installment

income to the net income of 1958 also produces a new measure of tax for the taxable year 1958.

Section 24672 does not affect the basis for measuring the tax for the taxable year 1958 as prescribed by Section 23222 without regard to Section 24672. Section 24672 provides merely that "the unreported income shall be included in the measure of the tax for the last year in which the taxpayer is subject to the tax measured by net income imposed under Chapter 2 . . ." The purpose of the section is to require that any income that has not been included in the measure of tax for a year prior to dissolution or withdrawal must be included retroactively in the measure of tax for the last taxable year. We find nothing in the purpose or intent of Section 24672 to support the position that it affects the measure of tax for the taxable year 1958.

The effect of the foregoing conclusion is that the deferred income from installment sales made in the income year 1958 will be included in the measure of tax for only the taxable year 1959 whereas, if the installment basis were not elected, the entire income would be included in the measure of tax for both taxable year 1958 and taxable year 1959, under Section 23222. However, that does not confer a special tax benefit on the instant taxpayer, because it is the result obtainable by any taxpayer who, pursuant to a proper election, reports sales made in the first full income year of 12 months on the installment method. Any taxpayer may eliminate deferred installment income from the two-year tax liability measured by income of the first full 12-month year of a commencing corporation, and it does not appear that this benefit derived from election to use the installment method in any way thwarts the commencing corporation provisions of the law or gives any unfair tax benefit to the instant taxpayer as compared to other taxpayers who do not dissolve or withdraw in 1959 but continue to do business thereafter.

In a similar factual situation in the Appeal of American Home Supply, Inc., decided May 19, 1954, the State Board of Equalization sustained action of the Franchise Tax Board which was in accord with the foregoing conclusion.

(2) Although precise authority is lacking on the question, it is concluded that income from installment sales is allocable by the apportionment formula computed for the year in which the income is reported. There is no compelling reason to deviate from the annual accounting concept, that is, determining each year's income (in the instant situation, each year's allocation) with reference only to the events of that year. In most, if not all, cases of income allocation, while the apportionment formula is computed from current year's sales, payroll, and property, at least some of the factors (a portion of the payroll and property) from which the income is derived entered the computation of a prior year's formula, and some of the same factors entering the current year's formula will be responsible for a subsequent year's income. In other words there is not, and cannot be, an absolute correlation between the income allocated in any year, and the amounts going into the factors making up the allocation formula. In

the case of installment sales, there is the additional circumstance that the actual sale activity occurred in a year prior to that in which the income is reported, but that is merely an additional instance of activity occurring in one year while income derived from it is reported in a subsequent year. And it does not require a deviation from the general practice of allocating income by a formula computed for the year in which the income is reported.

(3) In the situation where a corporation has disposed of all of its business assets except that it has retained its installment obligations which bear interest, it is "doing business" within the meaning of Section 23101, for purposes of imposition of the franchise tax, if it collects interest during the period. There appears to be no reason to ascribe any different meaning to the phrase "to do business" in Section 24672 than the meaning that has been developed for the phrase "doing business" in Section 23101. Therefore, it is concluded that a corporation which is collecting interest on installment obligations has not ceased to do business for purposes of Section 24672.