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QUESTIONS PRESENTED:

1. What is the impact of AB 10 and AB 1843 on the tax computation for the final taxable year for dissolving corporations?
2. Do we continue to impose the minimum franchise tax if a taxpayer has conditionally dissolved?

CONCLUSIONS

1. For taxable years beginning on or after January 1, 2000, except where the final tax year is also the first taxable year, the final year tax of a dissolving corporation should only include the tax measured by the income of the taxable year of the dissolution, withdrawal or cessation, or if greater, the minimum franchise tax.
2. Only foreign (non-CA) corporations should be assessed the minimum franchise tax for years they are conditionally dissolved, but not formally dissolved, by the Secretary of State due to the lack of a tax clearance certificate.

ANALYSIS AND DISCUSSION

The purpose of this memo is to set forth the major impact of AB 10 and AB 1843 on the computation of tax for the final taxable year for dissolving corporations. Two examples are provided to highlight the changes and demonstrate the impact on this final taxable year tax computation. There is also a brief discussion of when it is appropriate to impose the minimum franchise tax on a taxpayer that has "conditionally dissolved".

The law in effect prior to AB1843 imposed the franchise tax on corporations for the privilege of doing business as a corporation in California. The tax was for the privilege of doing business during the current taxable year, but the tax was "measured by" the amount of income earned during the prior income year, but could not be less than the minimum franchise tax. AB 1843 deleted from the Bank and Corporation Income Tax Law the "income year" versus "taxable year" distinction, by merging the "income year" and "taxable year" for taxable year 2000. (Rev. and Tax. Code section 23151(f)(1)(A) and (B).)

This awkward and confusing "income year" versus "taxable year" convention was adopted when the franchise tax was first imposed in 1929. At that time the tax on a new corporation for its first two taxable years was measured by the corporation's net income for its first year of business. However, this was changed in 1970, when the law was changed so that the tax for the corporation's first "taxable year" was simply equal to the minimum franchise tax (\$800) and was paid, upon incorporation or qualification, to the Secretary of State.

In 1996, the first year minimum franchise tax was reduced from \$800 to \$600. The minimum franchise tax on new, small corporations was further reduced to \$300 (payable to the Secretary of State) for the first year and \$500 for the second year, effective for incorporations occurring on January 1, 1999 and thereafter. (AB 2798, Chapter 323, Statutes of 1998.)

AB10 (chapters on July 6, 1999) provides that newly incorporated or qualifying corporations are not subject to the to the minimum franchise tax for their first and second taxable years commencing with tax years starting on or after January 1, 2000. (Rev. and Tax. Code section 23153(f)(1).)

AB 10 also repealed the initial \$800 minimum tax prepayment for new corporations, payable to the Secretary of State effective January 1, 2001. (Former Rev. and Tax. Code section 23221(g).)

AB1843 did away with the "income year"/"taxable year" distinction, changing all references to "income year" in the income and corporation tax laws to "taxable year". Rev. and Tax. Code section 23151.1(c) was amended by AB 1843, adding paragraph (2), which provided that tax for a given taxable year, including the taxable year of cessation, was now measured by net income for that same taxable year, not the prior "income year" as before the amendment. (Effective for taxable years beginning on or after January 1, 2000.)

AB 1843 added subdivision (f)(1)(A) and (B) to Rev. and Tax. Code section 23151, and did away with the "income year"/ "taxable year" dichotomy for taxable years beginning on or after January 1, 2000. Under the old law, the 1999 income year served as the measurement year for the 2000 taxable year. The tax could not be less than the minimum franchise tax. Under the new law, the 2000 taxable year is the measurement year for the 2000 taxable year, and the tax shall not to be less than the minimum franchise tax. The change from the old law to the new law results in two minimum franchise tax amounts being required for the 2000 taxable year. This result occurs because the tax for the first taxable year beginning on or after January 1, 2000 is the sum of the tax measured by net income for the preceding income year (but not less than the minimum tax) and the tax measured by net income for the first taxable year beginning on or after January 1, 2000 (but not less than the minimum tax). (Rev. and Tax. Code section 23151(f)(1)(A) and (B).)

Therefore, for taxable years following the 2000 taxable year, tax is measured by the income for the taxable year itself. Furthermore, estimate payments, are credited as payment for the privilege of doing business in the current taxable year.

1. Computation of Tax For Final Taxable Year.

Prior to AB1843, the final tax for a corporation dissolving, withdrawing, or ceasing to do business in this state was computed and measured by the net income for the final taxable year and the prior income year. Following the passage of AB 1843 (effective for taxable years beginning on or after January 1, 2000), the final tax for a corporation dissolving, withdrawing, or ceasing to do business is measured by its net income for the final taxable year only and shall not be less than the minimum tax. (Rev. and Tax. Code sections 23151, 23151.1(c)(2) and (e), 23151.2).

Rev. and Tax. Code section 23151.1, as amended by AB1843, states in pertinent part:

. . . (c)(2) With respect to taxable years beginning on or after January 1, 2000, (other than the first taxable year beginning on or after that date), the tax for the taxable year (including the taxable year of commencement and the taxable year of cessation) shall be according to or measured by its net income for the taxable year to be computed at the rate prescribed in Section 23151.

* * *

(e) In any event, the tax for any taxable year shall not be less than the minimum tax provided for in Section 23153 for that taxable year. (Emphasis added.).

Therefore, corporations, including nonqualified corporations, must pay at least the minimum franchise tax for the year they cease to do business. Rev. and Tax. Code section 23151.2 provides the same tax result for the final year of corporations incorporated or qualified with the Secretary of State. Rev. and Tax. Code section 23151.2 states:

[Liability for tax in year of dissolution or withdrawal]--
Notwithstanding Section 23151, every corporation (except banks and financial corporations) not exempted from taxation by the provisions of the Constitution of this state or by this part which dissolves or withdraws, shall pay a tax for its taxable year of dissolution or withdrawal according to or measured by

its net income for the taxable year in which it ceased doing business, unless that income has previously been included in the measure of tax for any taxable year, to be computed at the rate prescribed in Section 23151 for its taxable year of dissolution or withdrawal. In any event, the tax for the taxable year of its dissolution or withdrawal shall not be less than the minimum tax provided for in Section 23153 for that taxable year. (Emphasis added.)

Therefore, for taxable years beginning on or after January 1, 2000 (except for its first such taxable year), there is no longer a double measure for the tax for the year of cessation. Formerly, the tax in the year of cessation was measured by **both** the income for the final taxable year and net income for the prior "income year". Now, the final year tax is measured only by the net income for the taxable year in which the corporation ceased doing business. Furthermore, an estimate payment is no longer regarded as payment for the privilege of doing business in the following year, but is regarded as payment for the taxable year when the payment is made.

The following two examples demonstrate how the recent statutory changes affect the tax for the year of cessation. Both examples assume zero income, thus making the corporations subject to the minimum tax only. Example 1 illustrates a situation under the former law, while Example 2 illustrates the application of the new statutory changes.

Example 1 (Old Law):

Corporation X makes an \$800 estimate payment on April 15, 1998. In 1998, this 1998 estimate payment was regarded as a payment for the privilege of doing business in 1999, the following year.

Corporation X files its return for the 1998 taxable year showing an \$800 minimum tax liability for 1998 since it has never had any income. Pursuant to the 1998 return, the \$800 estimate payment made on April 15, 1998 is applied to satisfy \$800 minimum franchise tax liability for 1999.

On April 15, 1999, Corporation X makes another \$800 estimate payment, this time for the privilege of doing business in 2000. However, Corporation X dissolves as of December 31, 1999. Corporation X files its return of the 1999 income year showing an \$800 minimum franchise tax liability. The \$800 estimated tax payment made April 15, 1999 is shown as a payment on the return so that there is no balance due. Under the former law, the tax for this final taxable year (1999) is measured by income for two years, the next preceding year, 1998 and the current year, 1999, but not less than the minimum franchise tax of \$800. Since Corporation X had no income, it is only subject to the \$800 minimum tax liability for its final 1999 tax year. Corporation X receives an \$800 refund in post-

dissolution audit because it paid \$800 on April 15, 1999 for the privilege of doing business in 2000 but dissolved before December 31, 1999.

Example 2 (New Law):

Assume the same facts as for Example 1, except that Corporation X does not dissolve until December 31, 2001. Corporation X made an \$800 estimate payment on April 15, 1999. Under the old law, this payment was regarded as payment for the privilege of doing business in taxable year 2000. Corporation X also makes an \$800 estimate payment on April 15, 2000 and another on April 15, 2001. Under the new statutory provisions, the April 15, 2000 estimate payment is regarded as payment for the 2000 taxable year, not the following year. Two minimum franchise tax amounts are paid for the 2000 taxable year. (Rev. and Tax. Code section 23151 ((f)(1)(A) and (B).) The April 15, 2001, \$800 estimate payment is regarded as payment made for the 2001 taxable year.

When Corporation X dissolves on December 31, 2001, the tax for its final year is measured by the income for this final taxable year. Since Corporation X had a loss; it will owe the \$800 minimum tax for final taxable year 2001. Since Corporation X has already made an \$800 estimate payment in April of 2001 for the 2001 taxable year, Corporation X's liability has been met, and Corporation X does not receive a refund in connection with its dissolution and taxable 2001 return.

2. Conditional Dissolutions

Corporations that are conditionally dissolved by the Secretary of State have not received a Tax Clearance Certificate probably due to the failure to execute an assumption of liability.

Case law clearly holds that the corporation must pay the minimum franchise tax for each year until it is formally dissolved (*Appeal of BalDar Industries, Inc., Taxpayer, and Bruce F. Balent, Assumer and/or Transferee*, Cal. St. Bd. of Equal., 87-SBE-011, March 3, 1987). Also, as stated in California CCH paragraph 1-435, it is well settled that:

When a corporation is dissolved without court proceedings, the certificate of dissolution it files with the Secretary of State **must** contain an assumption agreement stating that some person or corporation will assume the tax liability, if any, of the dissolving corporation as security for a tax clearance certificate issued by the Franchise Tax Board. (*Corporations Code Sec. 1905*) The corporation is dissolved on the date the certificate of dissolution is filed **only** if the Franchise Tax Board notifies the Secretary of State that all taxes imposed on the corporation have been paid or secured. Thus, although the corporation's powers, rights, and privileges

cease on the certificate filing date, its corporate existence does not terminate until the Secretary receives the required assurance from the FTB. (*Corporations Code Sec. 1905*) (Emphasis added.)

However, Rev. and Tax. Code section 23153(g)¹ states:

Notwithstanding subdivision (a), a domestic corporation, as defined in Section 167 of the Corporations Code, that files a certificate of dissolution in the office of the Secretary of State pursuant to subdivision (c) of Section 1905 of the Corporations Code and that does not thereafter do business shall not be subject to the minimum franchise tax for taxable years beginning on or after the date of that filing. (Emphasis added.)

Accordingly, a domestic (California incorporated) corporation ceases to be subject to the minimum franchise tax if it files the certificate of dissolution with the Secretary of State, and thereafter does not engage in business here. However, foreign corporations remain subject to the minimum franchise tax until formally dissolved, even though the corporation has withdrawn from the state and filed its certificate of withdrawal with the Secretary of State.

This memo is not intended to be exhaustive or to address all possible issues or scenarios involving the minimum franchise tax and/or dissolutions. You are encouraged to contact the TAM author if you have questions about the subject of this TAM or any more specific questions regarding the minimum franchise tax.

Tax Counsel

¹ This section was originally added as subdivision (e) by AB 1415 (Stats. 1991, Ch. 309) operative for income years beginning on or after January 1, 1991.