



Legal Division MS A260
PO Box 1720
Rancho Cordova, CA 95741-1720

chair **John Chiang** | member **Jerome E. Horton** | member **Ana J. Matosantos**

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LEGAL RULING 2011-03

Subject: "Ceases Operation" Within the Meaning of Sections 17941 and 23153

BACKGROUND

Revenue and Taxation Code (RTC) sections 17941 and 23153 impose an annual minimum franchise tax on corporations and an annual tax on certain limited liability companies ("LLC") doing business in California. RTC sections 17941 and 23153 contain exceptions to the imposition of the tax for small businesses solely owned by deployed members of the United States Armed Forces for any year that the owner is deployed and the business operates at a loss or ceases operation.

ISSUE

When does a corporation or LLC "cease operation" for purposes of RTC section 17941, subdivision (f), or RTC section 23153, subdivision (i)?

FACTS

Assume the following facts:

Each of the following entities is validly formed or organized and operating as either an LLC, as defined in RTC section 17941, or a corporation, as defined in section 23038. Each entity is solely owned by a deployed member of the United States Armed Forces. None of the entities are operating at a loss for the taxable year. For purposes of this ruling, the business may be an incorporated entity or a single member limited liability company that is classified as a corporation or is disregarded as an entity separate and distinct from its owner for income and franchise tax purposes.

SITUATION 1

Entity A is winding up its business operations that extend beyond the close of its taxable year, but is otherwise not engaged in any active business operations.

SITUATION 2

Entity B files both a final tax return with Internal Revenue Service (IRS) and Franchise Tax Board and delivers a Certificate of Dissolution (for corporations pursuant to Cal. Corp. Code section 1905) or a Certificate of Cancellation (for LLCs pursuant to Cal. Corp. Code section 17356, subdivision (b)) to the California Secretary of State within 12 months of the filing date of the final return.

SITUATION 3

Entity C has zero gross income and zero gross expenses for the taxable year.

SITUATION 4

Entity D discontinues all business operations during the taxable year, but during the following year must defend itself in a lawsuit in state or federal court pursuant to California Corporations Code sections 2011 or 17355.

SITUATION 5

Entity E discontinues all business operations during the taxable year, but resumes operations during the following taxable year.

LAW & ANALYSIS

Existing law generally imposes a minimum franchise tax of \$800 on every corporation incorporated in this state, qualified to transact intrastate business in this state, or doing business in this state. An annual tax is also imposed in an amount equal to the minimum franchise tax on every limited liability company registered, qualified to transact business, or doing business in this state, that is not classified as a corporation.

Amendments to Sections 17941 and 23153 of the Revenue and Taxation Code were recently enacted to exempt a corporation or a LLC owned by a deployed service member from paying the minimum franchise tax or the annual tax under certain circumstances. The LLC or corporation is exempt from paying the minimum franchise tax or annual tax for the privilege of doing business in this state if the entity is a small business solely owned by a deployed member of the United States Armed Forces that ceases operations or operates at a loss. (AB 2671, Stats. 2010, ch. 394.) The provisions for deployed small business owners in RTC sections 17941, subdivision (f), and 23153, subdivision (i), apply to taxable years beginning on or after January 1, 2010.

In order to qualify for the exemption under RTC section 17941, subdivision (f), or RTC section 23153, subdivision (i), respectively, the LLC or corporation must either operate at a loss or "cease operation" during the taxable year.

HOLDING – SITUATION 1

In winding up its affairs, Entity A is considered to have ceased operations for purposes of RTC sections 17941. Pursuant to California Corporation Code sections 2000 et seq. (with regard to dissolution of corporations) and 17350 et seq. (with regard to dissolution of LLCs), a corporation or LLC may be dissolved and its affairs wound up in the following circumstances:

- Liquidations resulting in the sale of all business assets (excluding nonbusiness assets (such as artwork) or certain assets that cannot be sold (for example, an FCC license, patent license with assignment restrictions or real property for which no reasonable buyer can be found));
- Termination of all employees;
- Termination of all business contracts; and
- "Complete and final" closing of the books for the final year of operation pursuant to California Corporations Code sections 2010 and 17354. Contracts extending beyond the taxable year of liquidation are permitted, but must not be operational (e.g., rental of office space) and cannot result in the generation of income.

HOLDING – SITUATION 2

Entity B is considered to have ceased operations at the time it files final tax returns with IRS and California and delivers a Certificate of Dissolution or Certificate of Cancellation, as applicable, to the California Secretary of State.

HOLDING – SITUATION 3

Entity C is considered to have ceased operations for the taxable year.

HOLDING – SITUATION 4

Entity D is considered to have ceased operations, even if it must provide a legal defense or appear in court during the following year to defend against a lawsuit.

HOLDING – SITUATION 5

Entity E is considered to have ceased operations during the year in which it discontinues operations, even if it resumes operations during a subsequent taxable year. To qualify for the exemption, E must do all of the following:

- Cease operations contemporaneously with deployment;
- Cease operations for at least one (1) month during the taxable year;
- Not resume operations during the taxable year; and
- Cease operations for at least three (3) months, even if this period extends into the following taxable year.

If E resumes operations during the subsequent taxable year, it will no longer be considered to have ceased operations during that subsequent taxable year. For example, if E ceases operations on October 30, 2011 and resumes operations on January 30, 2012, E will qualify for the exemption for 2011. If E ceases operations on December 1, 2011, E cannot resume operations until March 1, 2012 or it will not qualify for the exemption in 2011. In either case, E will not qualify for the exemption in 2012.

DRAFTING INFORMATION

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