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Edward A. Weiss

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By Edward A. Weiss*

California imposes a franchise tax upon general commercial corporations,[1] with some exceptions,[2] as an excise tax for the privilege of doing business as a corporation within the state.[3] The tax, currently at the rate of 5.5 per cent of gross income,[4] is deemed to accrue on the first day of the taxable year[5] and is therefore being paid in advance of earnings by the corporation.

It is this factor which distinguishes the California franchise tax from the federal income tax on corporations. It is, similarly, this factor of prepayment which can serve to create inequities in application, which would not be present if the franchise tax were imposed as an income tax rather than merely measured by the corporate taxpayer's income.

To fully appreciate the possible inequitable situations requires an understanding of the procedure established by the legislature for the payment and computation of the tax.

Commencing or Qualifying a Corporation

Upon the incorporation or organization of a domestic corporation, a minimum tax must be paid . . . before the Secretary of State will allow it to incorporate, even though the corporation is not actively engaged in any business from which it may realize proceeds for the payment of the tax. In the case of a foreign corporation desiring to qualify to do business within California, this minimum tax must be paid before the certified copy of Articles may be filed with the Secretary of State.[6]

If the corporation commences its business during its first year, the tax for that year will be based upon its income for that year, with a prescribed minimum, in the amount of the required prepayment.[7] The

* B.S., University of California, 1953; LL.B., Hastings College of the Law, 1959; CPA; practicing attorney in Oakland, Calif.

1 Cal. Rev. & T.C. § 23151.

2 Cal. Rev. & T.C. §§ 23731, 23102.

3 Footnote 1 *supra.*

4 *Ibid.*

5 Cal. Rev. & T.C. § 23112.

6 Cal. Rev. & T.C. § 23221.

7 Cal. Rev. & T.C. § 23222.

return must be filed, as with the federal income tax, on the fifteenth day of the third month following the close of the taxable year.[8] (A corporation using a calendar year must file its return by April 15.)

The tax for the second year is computed on the basis of the income for the preceding year[9]—this being the basic difference between the franchise tax and an income tax in practical application. Thus, assuming a corporation on a calendar year, on April 15 following the close of the first year a tax is due for the first year *and* for the second year at the same time. (This is subject, of course, to a credit for the prepayment made upon the commencement of the corporation.[10])

There are exceptions, not pertinent to this discussion, providing for more complex apportionment where the first and/or second taxable years of the corporation were short years.[11]

If the corporation does not commence to do business immediately upon its incorporation, it will be subject only to the minimum tax until such time as it does actively engage in business.[12] Once active business is started, the method of computing tax follows the procedure previously outlined.[13]

Dissolving or Withdrawing a Corporation

Upon the dissolution of a domestic corporation or the withdrawal of a foreign corporation from its activities in California, a final return is required before the dissolution or withdrawal may be completed.[14] In the absence of a clearance by the Franchise Tax Board, no complete dissolution is possible.[15]

The tax for the final year is, ostensibly, prorated.[16] It is still based upon the earnings of the immediately prior year, but where the final year is a short year (as it most always is) the tax is only a prorata amount in accordance with the number of months of the final year that the corporation "existed." Once again, this is subject to the minimum tax.

On paper, this proration may appear to be relatively fair. In application, it very often is not.

To begin with, in the year of dissolution the corporation is generally not earning at its previous rate . . . but its tax is nevertheless

[8] CAL. REV. & T.C. § 25401.
[9] CAL. REV. & T.C. § 23222.
[10] *Ibid.*
[11] CAL. REV. & T.C. § 23222a.
[12] CAL. REV. & T.C. § 23223.
[13] *Ibid.*
[14] CAL. REV. & T.C. § 23333.
[15] CAL. REV. & T.C. § 23334.
[16] CAL. REV. & T.C. § 23332.

measured by the previous year's income.[17] Thus the first tax due was a double tax (covering two years) putting the corporation on a prepaid basis. The last tax due is then imposed on the assumed rate or measure of a *going corporation.*

Secondly, and this procedure is one which nowhere is sanctioned in the Code but which occurs with all too great a frequency, the imposition of the minimum rate may be inequitable. As has been noted, the corporation cannot dissolve effectively and cut off future liability for at least the minimum tax without receiving its tax clearance.[18] So long as it has not dissolved officially it is taxable even though not actively engaged in business operations.[19] A corporation seeking to dissolve or withdraw toward the end of its taxable year (i.e., a corporation on a calendar year attempting to dissolve on October 31st) will often be carried through the first of its next taxable year (i.e., January 10th) by the slow workings of the administrative agencies. This will impose upon it the full, *unprorated* tax for its actual final year of operations PLUS a minimum tax for the next year, which technically qualifies as its "last" taxable year.

The nature of the tax imposed by the Bank and Corporation Tax Law provides the clue as to how these strange machinations are allowed to continue.

Nature of the Franchise Tax

The tax is measured by the corporation's income.[20] A majority of the basic provisions with respect to gain and loss, deductions, gross and net income, and like provisions of both the California franchise tax and the California personal income tax have been adopted, sometimes bodily lifted, from their counterpart provisions of the Federal Internal Revenue Code. The California courts have, logically enough, recognized this factor along with the similarity between the regulations and administrative procedures of California with those of the federal income tax. The California courts have thus assumed, and based its decisions accordingly, that the California legislature expected its enactments to be treated the same as the federal counterparts and have used the federal interpretations in making its own construction of the franchise tax.[21]

The California courts have not felt free, however, to treat the franchise tax as an *income* tax in all respects. They have allowed it to

[17] *Ibid.*

[18] See footnote 16 *supra.*

[19] See footnote 1 *supra.*

[20] *Ibid.*

[21] Holmes v. McColgan, 17 Cal. 2d 426, 110 P.2d 428 (1941); Union Oil Associates

maintain its character as an excise tax, with the attendant inequities to the taxpayer and advantages to the body politic, while interpreting its construction as though it were an income tax.

The basis of this distinction in the nature of the franchise tax lies in the Constitution which specifically includes franchises when enuerating the types of property which may be taxed "in proportion to the value thereof,"[22] and follows with a provision authorizing the legislature to provide appropriate laws for the taxation of corporations and their franchises by any method not prohibited by the federal or state constitutions or federal laws.[23] This evolved into the tax on "every corporation doing business within the limits of this state" (with specified exemptions) "for the privilege of exercising its corporate franchises within this state."[24] The tax, although not an income tax, is "according to or measured by its net income," with the prescribed minimum.

Again semantically, this tax has been held by the California courts to be not an income tax, nor a direct tax, nor a property tax, nor yet a tax for the privilege of *being* a corporation. It is merely a tax on the *privilege of exercising its corporate franchise.*[25]

Although technically and legally the state has the right to exact its franchise tax, why should it not do so by labeling it and treating it as an *income* tax? It would exact virtually the same revenues, and would serve to simplify the entire procedure by which corporations could commence and dissolve. Moreover, minds trained in commerce but foreign to the niceties of legal terminology (creating distinctions through semantics where, in fact, none would otherwise exist) might more fully understand the workings of this law and be better able to establish reserves where necessary to guard against a surprise tax assessment, and thereby forego the necessity of having to de delayed in their dissolution.

If what the state desires is to guarantee that it will have its tax prepaid, admittedly this could not be done practically through the use of a corporate *income* tax. It could, however, be done by retaining it as a franchise tax and adjusting the provisions setting forth the method of computing the tax due, especially upon dissolution. After setting up

v. Johnson, 2 Cal. 2d 727, 43 P.2d 291 (1935); Innes v. McColgan, 47 Cal. App. 2d 781, 118 P.2d 855 (1941); Meanly v. McColgan, 49 Cal. App. 2d 203, 121 P.2d 45 (1942).

[22] CAL. CONST. art. XIII, § 1.

[23] CAL. CONST. art. XIII, § 16, subd. 2.

[24] See footnote 1 *supra*.

[25] Rosemary Properties, Inc. v. McColgan, 29 Cal. 2d 677, 177 P.2d 757 (1947); West Publishing Co. v. McColgan, 27 Cal. 2d 705, 166 P.2d 861 (1947), *aff'd* 328 U.S. 823; Bank of Alameda County v. McColgan, 69 Cal. App. 2d 464, 159 P.2d 31 (1945).

the first tax due as a double period tax in order to start the prepayment procedure, during the active life of the corporation it would remain on a prepayment basis. Upon its dissolution, however, there would be no reason to require a minimum tax to be paid. This serves merely to penalize the corporation for not being actively engaged in business, and imposes a penalty at a time when it perhaps can be least afforded.

Moreover, if the state is that anxious to have its taxes prepaid, why should it limit this procedure solely to corporations? The federal government obtains prepayments, or at least concurrent payments, of its *income* taxes through withholding proceedings[26] and requiring payments of estimated tax.[27] This could be done, with little administrative difficulty, in the state by requiring estimates by its corporations, and meanwhile not engaging in the legal gymnastics of terming this a franchise tax, while imposing it with the same construction as the federal government does its income tax.

Finally, if the state wishes to adhere to its characterization of the franchise tax as one imposed for the privilege of exercising the corporate franchise, it would appear more reasonable to eliminate the minimum tax requirement imposed on corporations which merely exist without engaging in active business. As a practical matter, corporations which are commercially unsuccessful are often loathe to dissolve properly because of the expense involved and will permit themselves to be "dissolved" by the state and accumulate paper tax liability until their corporate privileges are withdrawn.[28]

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[26] INT. REV. CODE OF 1954 § 3401.

[27] INT. REV. CODE OF 1954 §§ 6015, 6016.

[28] CAL. REV. & T.C. § 23301.