Accrual of liability for California franchise tax. This ruling holds that, for federal income tax purposes, a taxpayer that uses an accrual method of accounting incurs a liability for California franchise tax in the taxable year following the taxable year in which the tax is incurred under the California Revenue and Tax Code. Rev. Rul. 79–410 amplified.

Rev. Rul. 2003–90

ISSUE

For taxable years beginning on or after January 1, 2000, when does a taxpayer using an accrual method of accounting incur a liability for California franchise tax for federal income tax purposes?

FACTS

X is a corporation that uses an accrual method of accounting and files its federal income tax return on a calendar year basis. X has conducted business in California continuously for several years and is required to pay a franchise tax imposed under § 23151 of the California Revenue & Taxation Code (Cal. Rev. & Tax. Code) (West 1998 & Supp. 2002). In 2002, X has net income attributable to California of $10,000. X remits payments of estimated California franchise tax of $884 during 2002. Under California law, X's franchise tax liability for 2002 is $884, determined on the basis of X's 2002 net income attributable to California of $10,000.

LAW AND ANALYSIS

Section 164(a) of the Internal Revenue Code allows a deduction for certain taxes paid or accrued during the taxable year including state franchise taxes imposed on corporations.

Section 461(a) provides that the amount of any deduction or credit is taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income.

Section 1.461–1(a)(2)(i) of the Income Tax Regulations provides that under an accrual method of accounting, a liability is incurred 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. Section 1.461–4(g)(6)(i) generally provides that if the liability of a taxpayer is to pay a tax, economic performance occurs as the tax is paid to the governmental authority that imposed the tax.

However, § 461(d) provides that, in the case of a taxpayer whose taxable income is computed under an accrual method of accounting, to the extent the time for accruing a tax is earlier than it would have been but for any action of any taxing jurisdiction taken after December 31, 1960, the tax is to be treated as accruing at the time it would have accrued but for the action by the taxing jurisdiction. Section 1.461–1(d)(1) provides that any action by a taxing jurisdiction that results in the acceleration of the accrual of any tax is to be disregarded in determining the time for accruing the tax for purposes of the deduction allowed for the tax, with respect to both taxpayers upon which the tax is imposed at

the time of the action, and taxpayers upon which the tax is imposed at any time subsequent to the action.

Section 1.461–1(d)(1) further provides that, whenever an acceleration of the time for accruing a tax is to be disregarded, the taxpayer shall accrue the tax at the time the tax would have accrued but for the accelerating action (original accrual date). Section 1.461–1(d)(1) also provides that in the absence of any action of the taxing jurisdiction placing the time for accruing the tax at a time subsequent to the original accrual date, the taxpayer shall continue to accrue the tax as of the original accrual date for all future taxable years.

Section 1.461–1(d)(2)(iii) provides that the term "any action" includes the enactment or re-enactment of legislation, the adoption of an ordinance, the exercise of any taxing or administrative authority, or the taking of any other step, the result of which is an acceleration of the accrual event of any tax.

Cal. Rev. & Tax. Code § 23151 (West 1998 & Supp. 2002) imposes a franchise tax for the privilege of doing business as a corporation within California. For years beginning before January 1, 2000, the tax generally was measured by the net income of the year preceding the year for which the tax was imposed, subject to a minimum tax, with special rules for corporations commencing or ceasing business in California. Cal. Rev. & Tax. Code, § 23151.1 (West 1998 & Supp. 2002). The year in which the tax was imposed and payable was a corporation's "taxable year" ("California taxable year"). Cal. Rev. & Tax. Code § 23041(a) (West 1998 & Supp. 2002). The income year ("California income year") was defined as the "year upon the basis of which the net income is computed." Cal. Rev. & Tax. Code § 23042(a) (West 1998 & Supp. 2002). Thus, in the case of an ongoing corporation, the tax due for a California taxable year for the privilege of exercising the corporate franchise during the California taxable year was calculated based on the net income earned during the preceding year (the California income year).

Under pre-1961 California law, a corporation's liability for the franchise tax became fixed upon the corporation's exercise of the franchise in the California taxable year. *Central Investment Corporation v. Commissioner*, 9 T.C. 128 (1947), *aff'd* 167 F.2d 1000 (9th Cir. 1948). A corporation that ceased to do business in California had no liability to pay franchise tax measured by income earned in the final year of operation if the corporation did not exercise its franchise in the following California taxable year. Thus, under pre-1961 California law, a continuing corporation did not have a fixed liability to pay California franchise tax with respect to income earned in Year 1 (the California income year) until the corporation exercised its corporate franchise in Year 2 (the California taxable year). As a result, for purposes of § 1.461–1(a)(2), the corporation did not have a fixed liability in Year 1 for the California franchise tax with respect to income earned in Year 1, but rather the liability for California franchise tax with respect to income earned in Year 1 became fixed in Year 2, when the corporation exercised its corporate franchise. See *Hallmark Cards , Inc. v. Commissioner*, 90 T.C. 26 (1988).

Rev. Rul. 79–410, 1979–2 C.B. 213, addresses the timing of the deduction for California franchise tax liabilities and the application of § 461(d) to California law for years after 1972. Amendments to California law in 1971 and 1972 required a corporation ceasing to do business after December 31, 1972, to pay a franchise tax in its final year of operation based upon both the preceding year's net income and the net income earned in the corporation's final year. The ruling concludes that the 1971 and 1972 amendments caused the liability for California franchise tax to become fixed for purposes of § 1.461–1(a)(2) in the California income year. However, because the fixing of the liability in the California income year was earlier than when the liability became fixed under pre-1961 California law, the ruling concludes that, pursuant to § 461(d), the amendments are disregarded and the liability continues to be incurred for federal income tax purposes in the California taxable year, the taxable year in which the liability became fixed under pre-1961 California law. See also *Epoch Food Service, Inc. v. Commissioner*, 72 T.C. 1051, 1054 (1979).

For taxable years beginning on or after January 1, 2000, the Cal. Rev. & Tax. Code was amended to replace references to the term "income year" with the term "taxable year" ("redefined California taxable year"). Cal. Rev. & Tax. Code § 23042(b) (West Supp. 2002). As a result, the California franchise tax is measured by the net income of the year in which the tax is imposed and payable. Cal. Rev. & Tax. Code § 23151.1(c)(2) (West Supp. 2002). The transition year (2000) was the California taxable year under the former law with respect to income earned in 1999, and also the redefined California taxable year under the amendment for income earned in the first taxable year beginning on or after January 1, 2000. The accompanying legislative history states, however, that there was no intent to change the amount of tax or the timing of payment. See 2000 Cal. Stat. 862 (Sept. 29, 2000).

Under § 1.461–1(a)(2)(i), the liability for California franchise tax is established and the amount can be determined with reasonable accuracy in the taxable year that the net income is earned. However, when compared to pre-1961 California law, the 2000 amendment to the California law, like the 1971 and 1972 amendments, accelerates the accrual of the franchise tax for a continuing corporation from the taxable year following the taxable year in which the net income is earned to the taxable year in which the net income is earned. Thus, pursuant to § 461(d), the 2000 amendment must be disregarded and the liability for California franchise tax continues to be incurred for federal income tax purposes in the California taxable year, the taxable year in which the liability became fixed under pre-1961 California law.

Therefore, for taxable years beginning on or after January 1, 2000, X incurs a liability for California franchise tax for federal income tax purposes in the taxable year that follows the taxable year in which X earns the income on which the tax is measured. The California franchise tax of $884 that X pays in 2002, based on the $10,000 of net income that X earns in 2002, is deductible on X's federal income tax return for taxable year 2003.

HOLDING

For taxable years beginning on or after January 1, 2000, a taxpayer that uses an accrual method of accounting incurs a liability for California franchise tax for federal income tax purposes in the taxable year following the taxable year in which the

California franchise tax is incurred under the Cal. Rev. & Tax. Code, as amended.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 79–410 is amplified.

DRAFTING INFORMATION

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