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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR: Associate Area Counsel, Large & Mid-Size Businesses
ATTN: Joyce M. Marr

FROM: Associate Chief Counsel (Income Tax & Accounting)
Branch 1
CC:IT&A:01

SUBJECT: Applicability of I.R.C. § 461(d) to timing of state franchise tax deductions on federal tax returns by an accrual method taxpayer

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LEGEND

	=	State X
$	=	Amount A
$	=	Amount B
	=	Year 1
	=	Year 2
	=	Year 3
	=	incorporation date
	=	Date C
	=	Date i
	=	Date ii
	=	Date iii
	=	Date iv

ISSUE

What are the proper years in which an accrual method corporate taxpayer may deduct on its federal tax returns California franchise taxes in the amounts of Amount A and Amount B based on income earned in Year 1 and Year 2 respectively.

CONCLUSION

Taxpayer may deduct California franchise taxes in the amount of Amount A, based on income earned in its Year 1 California year, on Date ii, the following taxable year. Taxpayer may deduct California franchise taxes in the amount of Amount B, based on income earned in its Year 2 California year, on Date iv, the following taxable year.

FACTS

Taxpayer was incorporated in State X on incorporation date. Taxpayer commenced doing business in California on Date C, and is required to pay a franchise tax imposed under Article 2, section 23151 of the Bank and Corporation Tax Law. Taxpayer uses the accrual method of accounting for tax purposes.

Taxpayer declared a California franchise tax liability of Amount A on its first California return based on income earned in its first calendar year running from Date C through Date i. Taxpayer deducted this amount on its Year 1 federal return. Similarly, in Year 2, taxpayer reported a franchise tax liability of Amount B on its second California return based on income earned in the calendar year of Date ii through Date iii, and deducted this amount on its Year 2 federal return.

LAW AND ANALYSIS

Section 164(a) permits taxpayers to deduct state and local taxes which are paid or accrued within the taxable year in carrying on a trade or business.

An accrual basis taxpayer may deduct an expense for the taxable year in which all the events have occurred which determine the fact of the liability, the amount thereof can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Treas. Reg. § 1.461-1(a)(2)(i). Economic performance generally occurs for tax liabilities as the tax is paid. Treas. Reg. § 1.461-4(g)(6)(i).

Section 461(d), which relates to the accrual of taxes, is an exception to the general timing rules for deductions by accrual basis taxpayers. The section provides that in the case of an accrual basis taxpayer, to the extent that the time for accruing taxes is earlier than it would be but for any action of any taxing jurisdiction taken after December 31, 1960, such taxes are to be treated as accruing at the time they would have accrued but for such action by such taxing jurisdiction. The regulations broadly define "any action" as including the enactment or reenactment 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. Treas. Reg. § 1.461-1(d)(2)(iii). The action is to be disregarded not only by a taxpayer upon whom the tax is imposed at the time of the action, but also any taxpayer upon whom the tax is imposed at any time subsequent to such action. Treas. Reg. § 1.461-1(d)(1). The purpose of section 461(d) is to deny an accrual basis taxpayer the right to deduct more than one year of state taxes in the same federal taxable year. S. REP. NO. 1910, 86th Cong., 2d Sess. 7 (1960).

Every non-financial corporation organized in California, and every foreign corporation doing business in California, is subject to an annual franchise tax. Cal. Rev. & Tax. Code § 23151(a). A corporation is taxed on the privilege of exercising its corporate franchise in the taxable year, and the tax is measured by a percentage of its net income from the immediately preceding year, or income year. Id. See generally Williamette Industries v. Franchise Tax Board, 91 Cal. App. 3d 528, 532 (Cal. Ct. App. 1979) (franchise tax is not an income tax upon net income of taxable year but a tax on the privilege of doing business measured on net income of preceding year). A corporation's taxable year is defined as the year in which the tax is payable, and the income year is defined as the "year upon the basis of which the net income is computed." Cal. Rev. & Tax. Code §§ 23041(a), 23042(a).

The California statutes contain special provisions for the accrual of franchise taxes for the first and final years in which a corporation does business. Under the current statute, if a corporation commences doing business on or after January 1, 1972, it pays a minimum franchise tax which constitutes the entire tax for its first year. Cal. Rev. & Tax. Code § 23151.1(a). The minimum tax is paid upon incorporation. Cal.

Rev. & Tax. Code § 23153(a). The franchise tax for its second year is computed on the basis of the corporation's net income for its first year. Cal. Rev. & Tax. Code § 23151.1(c). The tax for the corporation's second year is paid during the first year and is based on the corporation's estimate of its first year net income. Cal. Rev. & Tax. Code § 23151(a). The tax for subsequent years is measured by the net income earned during the next preceding year. Id.

Effective January 1, 1973, in the year a corporation dissolves, it must pay any remaining tax due on the net income of its preceding year, and a tax on its final year's net income, minus the amount of minimum tax paid in the first year. Cal. Rev. & Tax. Code § 23151.1(d).

Revenue Ruling 79-410 addresses the accrual of California franchise taxes for a commencing corporation with a full first year for federal tax purposes. Analyzing the current California statutes, described above, the ruling indicates that the franchise tax based on a corporation's first year income accrues for federal tax purposes on the last day of that year. Applying the all events test, the ruling explains that the corporation's earning of net income in the income year is the event which fixes the liability for the tax, as well as the fact that the tax is due in that year.

In determining whether the current law represents an action accelerating the accrual of the franchise tax, as provided in section 461(d), we must examine the California franchise tax statutes effective prior to January 1, 1961. For a commencing corporation with a full first year, the statute provided as follows:

> If a taxpayer commences to do business in this state during its first taxable year its tax for that year shall be adjusted upon the basis of the net income received during that taxable year, at the rate applicable to that year, a credit being allowed for the prepayment of the minimum tax. The return for the first taxable year, which shall be filed within 2 months and 15 days after the close of that year, shall also be the basis for the tax of said taxpayer for its second taxable year, if its first taxable year is a period of 12 months. Cal. Rev. & Tax. Code § 23222(a).

Under this provision, a commencing corporation was required to pay a minimum tax upon incorporating. Cal. Rev. & Tax. Code § 23222(a). The franchise tax for its first year (assuming the first year was a full year) was based upon its net income for that year. Id. The California return for the first taxable year was due on the 15th day of the second month after the close of that year. Cal. Rev. & Tax. Code § 23222(a). The tax shown on the first year's return also served as the basis for the second year's tax. Cal. Rev. & Tax. Code § 23222(a). Thus the franchise tax for a corporation's first and second years was based on the net income earned in its first year to start the cycle of paying the tax based on the income of the next

preceding year. Under this payment scheme, the third year's tax would be based on the net income earned in the second year, and the tax for a corporation's subsequent years would be based on the income of the next preceding year. Prior to January 1, 1973, a dissolving corporation was not required to pay a franchise tax based on the net income earned in its final year. Cal. Rev. & Tax. Code § 23332(a). Rather, the corporation paid a prorated amount based on the preceding year's net income and the number of months it was in existence in the dissolving year. Id.

Also addressing the pre-1961 statutes for commencing corporations with a full first year, Rev. Rul. 79-410 concluded that the California franchise tax for a commencing corporation accrued on the first day of the taxable year following the income year, rather than on the last day of the income year, since the event fixing the tax liability was a corporation's exercise of its corporate franchise in the taxable year and not the earning of income during the preceding income year. In reaching this conclusion, the revenue ruling relied on the case of Central Investment Corp v. Commissioner, 9 T.C. 128, 132, 133, aff'd, 167 F.2d 1000 (9th Cir.), cert. denied, 335 U.S. 826 (1948). Examining pre-1961 law, the Tax Court reasoned that since a corporation's withdrawal or dissolution relieved it from taxation for that portion of the taxable year during which its corporate franchise was not exercised, the franchise tax must be for the privilege of doing business in taxable year because the net income earned in the corporation's final year was never taxed. Id. at 133. The court reached this conclusion despite the fact that the relevant statute provided that the tax accrued and a lien attached on last day of the income year. Id. at 132, 133.

Thus the amendments to the California franchise tax statutes effective after 1971 and 1972, which required corporations to pay their franchise tax by the last day of the income year and dissolving corporations to pay a franchise tax in their final year of operation based on the net income earned in the dissolving year, accelerated the date for the accrual of California franchise taxes from the first day of the taxable year (under pre-1961 law) to the final day of the income year. See also Epoch Food Service, Inc. v. Commissioner, 72 T.C. 1051, 1052, 1054 (1979). Although involving non-commencing corporations, the Tax Court held in Epoch that since the 1972 amendments to California franchise tax statutes imposed a franchise tax in a corporation's final year of operation, liability for the tax based on the prior year's net income no longer depended upon the corporation operating during the following taxable year. Id. at 1054. The event which fixed liability for the franchise tax was the earning of net income in the income year. Id. Since this amendment constituted a "state action" which accelerated the accrual date, section 461(d) applied to prevent the accrual of California franchise taxes on the last day of the income year and to defer the deduction to the subsequent taxable year. Id. at 1054. Accord Hitachi Sales Corporation v. Commissioner, T.C. Memo. 1992-504.

Pursuant to the Tax Court precedent cited above, as well as Revenue Ruling 79-410, taxpayer should not be allowed to deduct its California franchise taxes on its federal returns until the taxable years following the income years of Year 1 and Year 2.

You question whether the Tax Court's analysis in Charles Schwab Corp. v. Commissioner, 107 T.C. 282 (1996), aff'd on other gds., 161 F.3d 1231 (9th Cir. 1998), is applicable to the facts of the present case. Unlike the taxpayer in the present case, Schwab involved the timing of the accrual of California franchise taxes of a commencing corporation with a short first year. The Tax Court held that Schwab could deduct California franchise taxes based on income from its second California year on its federal return for its second federal taxable year. Schwab, 107 T.C. 282, 300. The Tax Court determined that section 461(d) was not applicable since there was no action taken by the taxing jurisdiction after December 31, 1960 which accelerated the date for the accrual of franchise taxes. Id. at 300.

Schwab commenced doing business in California on April 1, 1987, and at that time it was required to pay the minimum franchise tax required by Cal. Rev. & Tax. Code § 23151.1(a). This amount constituted its entire franchise tax for 1987 under Cal. Rev. & Tax. Code § 23151.1(a). Schwab's first California year was a short year, running from April 1, 1987 to December 31, 1987. On its first California return, Schwab reported a franchise tax of $879,500. Id. at 290. Although on a calendar year period for state tax purposes, Schwab was on a fiscal year period for federal tax purposes in 1987. Id. Schwab deducted the minimum tax it paid in 1987, and the franchise tax of $879,500 which it owed for the income year ending December 31, 1987, on the federal return it filed for its first federal fiscal year running from April 1, 1987 to March 31, 1988. Id. at 290, 291. [1]

For its second California income year, running from January 1, 1988 to December 31, 1988, Schwab reported a franchise tax of $932,979 on its second California return, and paid said amount in 1988. Id. at 291. Schwab switched to a calendar year for its second federal year, which ran from April 1, 1988 to December 31, 1988. Id. at 290. Although Schwab deducted this amount on its federal return for 1989 pursuant to Revenue Ruling 79-410, it subsequently argued that it incorrectly relied on this ruling and should be entitled to deduct this amount on its 1988 federal return. Id. at 300. In taking this position, Schwab relied upon the California

[1] The parties agreed that Schwab properly deducted its franchise tax for the first California year in its first federal tax year ending March 31, 1988. The parties only agreed on this point because Schwab's first federal year was a fiscal year. Schwab contended that the $879,500 in franchise tax accrued for federal tax purposes on December 31, 1987, while respondent argued that it accrued on January 1, 1988. Id. at 296.

statutory provisions applicable before January 1, 1961 to commencing corporations with a short first year. Id. at 298. Section 23222(a) of the California Revenue and Taxation Code, in effect prior to January 1, 1961, provided as follows:

> In every case in which the first taxable year of a taxpayer constitutes a period of less than 12 months, or in which a taxpayer does business for a period of less than 12 months during its first taxable year, said taxpayer shall pay as a prepayment of the tax for its second taxable year a tax based on the income for the first taxable year computed under the law and at the rate applicable to the second taxable year, the same to be due and payable at the same times and in the same manner as if that amount were the entire amount of its tax for that year; and upon the filing of its tax return within 2 months and 15 days after the close of the second taxable year it shall pay a tax for said year, at the rate applicable to that year, based upon its net income received during that year, allowing a credit for the prepayment; but in no event, except as provided in Section 23332, shall the tax for the second taxable year be less than the amount of the prepayment for that year, and said return for its second taxable year shall also be the basis for the tax of said taxpayer for its third taxable year, if the second taxable year constitutes a period of 12 months.

Under this provision, a short year commencing corporation prepaid its franchise tax for the second year based on the income earned in the first taxable year (computed at the second year tax rate). There was no separate tax liability for the first short year based on the income earned during that year. The corporation was responsible for paying a minimum tax upon incorporation pursuant to California Revenue and Taxation Code §§ 23153, 23221. The income for the first short year was used solely to compute the amount of prepayment for the second year franchise tax. Once the taxpayer earned income during its second year, it paid a franchise tax based on its net income for the second year with its return after the close of that year. The taxpayer received a credit for the prepayment of its second year tax. The tax for the corporation's third year was based on the tax for its second taxable year, assuming the second taxable year was a full year. Thus the franchise tax for a corporation's second and third taxable years was measured by its second year income. This placed the corporation on a prepayment schedule so that the franchise tax for the third year was based on the income earned in the second year, and the income from the next preceding year would have been used as a basis for the franchise tax for the following taxable year.

Schwab contended that the pre-1961 provision fixed its liability for the California franchise tax based on the income from its second California year on the last day of its second California year, December 31, 1988. Schwab, 107 T.C. at 299. Schwab believed that the franchise tax liability based on income from its first and second

years accrued on the last day of those respective years under the pre-1961 and current statutes. Id. Schwab argued that its first California year (from April 1, 1987 to December 31, 1987) served as its first income year and first taxable year, and that its franchise tax liability would be fixed at the close of that year. Schwab, 107 T.C. at 298, 299. Schwab similarly maintained that its second California year served as both its second income and taxable year. Id. at 299. Because the franchise tax based on income earned in its second year accrued on the last day of the second year under both the pre-1961 and current statutes, Schwab reasoned that the accrual date did not change, and therefore section 461(d) did not apply. Id. Respondent maintained that under the pre-1961 California statute, Schwab's $932,979 tax liability accrued on January 1, 1989, the first day of the taxable year following the 1988 income measurement year, citing Central Investment. Id. at 298; Respondent's Brief at 54, Schwab (No. 1271-92). Under Cal. Rev. & Tax. Code § 23151.1, the current statute, respondent asserted that the franchise tax based on its second year income accrued on December 31, 1988, the last day of the 1988 income year, since the event fixing liability for the California franchise tax was the earning of net income in the income year. Respondent's Brief at 54. Citing Epoch and Hitachi, respondent concluded that section 461(d) applied since current law accelerated the accrual date to the last day of the income year and, therefore, Schwab could not deduct the $932,979 in franchise taxes until the first day of the taxable year 1989. Respondent's Brief at 63. Respondent also argued that Schwab's decision to change the accrual date of its franchise tax liability from January 1, 1989 to December 31, 1988 was a change of accounting method for which it did not obtain the Commissioner's consent. Schwab, 107 T.C. at 300.

The court acknowledged that in general the California franchise tax accrued on the first day of the taxable year under the pre-1961 statute since the tax was imposed for doing business during the taxable year (citing Central Investment), and that the current statute changed the accrual date for franchise taxes from the first day of the taxable year to the last day of the income year since the tax was based on the earning of net income in the income year (citing Epoch). Id. at 297. The court noted that these authorities did not address the special rules contained in Cal. Rev. & Tax. Code § 23222(a), the pre-1961 statute, for a corporation with an initial short year. Id. at 299. The court concluded that pursuant to this section, Schwab could accrue its franchise taxes based on income earned in its second California year, running from January 1, 1988 to December 31, 1988, on the last day of 1988. Id. at 300.

In reaching this conclusion, the court agreed with Schwab that 1987, its first California year, served as both its first income and first taxable year since it was a short year. Id. at 299. The Tax Court applied the all events test to determine the proper time for the accrual of Schwab's franchise taxes for its short initial year and second year. Id. The Court reasoned that Schwab's franchise tax liability for income earned in its short first year would have become fixed on the last day of the

first year since the tax would be payable for the privilege of exercising the corporate franchise for this short period. Id. The court similarly concluded that Schwab's second California year, 1988, served as both the second income year and second taxable year, since the franchise tax liability would be based on income earned during that year and would not have depended on an event subsequent to the end of that year. Id. at 299, 300. The court noted that the income from the short first year was not used to compute the franchise tax for the second taxable year. Id. Since Schwab's franchise tax for its second taxable year would be based solely on its second year income and would be payable for the privilege of exercising the corporate franchise during the second year, the court reasoned that the accrual of this amount would not have depended upon occurrence of an event subsequent to end of the second year and, accordingly, all events necessary to fix the taxpayer's liability for the franchise tax would have occurred at the close of 1988, its second California year. Id. The second California year would also have served as the third income year. Id. Analyzing in dicta the accrual of taxes for January 1, 1989 through December 31, 1989, Schwab's third California year, the court noted that its franchise tax liability would have accrued on January 1, 1989, the first day of the third California year. Id. at 300, fn. 10.

The court rejected respondent's argument that section 461(d) applied to prevent Schwab from deducting California franchise taxes based on income earned in 1988 until 1989, as respondent failed to account for the pre-1961 statute governing commencing corporations with a short initial year. Id. at 300. Since the court determined that Schwab's franchise tax liability based on income earned in its second California year accrued at the end of 1988 under the pre-1961 and current statutes, the court concluded that section 461(d) did not apply and Schwab could therefore deduct the $932,979 on its 1988 federal return. Id.

The court also rejected respondent's change of accounting argument. It explained that Schwab did not change its accounting method, but misconstrued Revenue Ruling 79-410 to include commencing corporations with a short first year. Id. at 301. The court explicitly distinguished the revenue ruling from the present facts, noting that the ruling was limited to commencing corporations for which the first year was not a short year. Id. at 301, n. 11. The court held that Schwab's decision to change its accrual date was based on the "fact" that the first year was a short year, and such action was a correction of an error rather than a change in its method of accounting. Id.

To determine whether the Tax Court's analysis in Schwab is applicable to the present case, we must examine the similarities and differences between the accrual dates under the pre-1961 statutes for full year commencing corporations and short year commencing corporations.

Pre-1961 Provisions for Commencing Corporations with Short and Full First Years

As set forth in detail below, the years in which the California franchise tax accrued for corporations with an initial short year versus an initial full year are the same.

Commencing Corporations with a Short First Year

The franchise tax for the first California taxable year was a minimum tax paid upon incorporation (pursuant to Cal. Rev. & Tax. Code § 23153). In contrast to current law, there was no separate tax liability for the first short year based on income earned during that year. Rather, the taxpayer was required to prepay its second year tax based on income earned in its first year. As stated in Schwab, the first California year constituted the first income year and the first taxable year. The franchise tax was fixed at the end of the first year since it was based on a corporation's exercise of its franchise that year.

The franchise tax for the second taxable year accrued in the second California year since it was based solely on the income earned in that year and since the corporation exercised its corporate franchise for that year. As was the case with the first year, the second California year served as both the second income year and the second taxable year.

The third year franchise tax accrued in the third California year following the second income measurement year. Although based on income earned in the second California year, the third year franchise tax did not accrue in the second California year since the corporation did not exercise its corporate franchise for the third California year until the beginning of that year.

Commencing Corporations with a Full First Year

Pursuant to section 23222(a), a commencing corporation with a full first year was required to pay a separate tax for its first and second taxable years based on its net income earned in the first year. As with short year commencing corporations, the income from one year was used to measure the tax for two years. [2] The franchise tax for the third California taxable year would have been based on the net income earned in the preceding second California year. Applying Central Investment and Rev. Rul. 79-410, the franchise tax liability for the first full California taxable year under pre-1961 law would have been accruable at the end of the first year. During the first year, the event which fixed the liability (i.e. the corporation's exercise of its corporate franchise) occurred. As with short year commencing corporations, the first year served as both the first income year and the first taxable year because at

[2] For short year commencing corporations, it was the income from the second California year that was used to measure the second and third year franchise taxes.

the end of the first year, the franchise tax for the corporation's first full year would have been computed on income earned during that period and would have been payable for the privilege of exercising the corporate franchise for that same period.

The franchise tax for the second year was also based on the income earned in the first year, and thus the first California year would have served as both the first income year and the second income year. The franchise tax for the second California taxable year would have accrued on the first day of the following taxable year, since at that time the corporation would have begun to exercise its corporate franchise for the second year. Even though the amount of the franchise tax for the second California taxable year was determinable at the end of the first year (since it was based on the first year's income), the franchise tax was based on the privilege of exercising the corporate franchise in the second year, and the corporation did not begin to exercise this privilege until the start of the second California year. Similarly, the franchise tax liability for a corporation's third California taxable year would have accrued on the first day of the taxable year following the second California year, even though the franchise tax for the third year was determinable at the end of the second California year since that year also served as the third income year.

Thus, under pre-1961 law, the franchise tax for the first California taxable year accrued at the end of the first California year, the franchise tax for the second California taxable year accrued in the second California year, and the franchise tax for the third California taxable year accrued in the third California year for commencing corporations, regardless of the length of their initial year.

Current Law for Commencing Corporations

Under current law, the accrual dates are the same for all commencing corporations, regardless of the length of their first year, since all corporations are governed by Cal. Rev. & Tax. Code § 23151.1. As discussed above, for a corporation's first year under current law, the first and second year franchise taxes would accrue at the end of the first year. The first year minimum tax accrues in the first year since it is paid in that year. Rev. Rul. 79-410. The second year franchise tax, based on the net income earned in the first year, also accrues at the end of the first year since the event fixing the liability is the earning of net income in first year, and the tax is paid in the first year. The third year franchise tax, based on income earned in the second year, accrues in the second year since the second year income (on which the tax is based) is earned in that year, and the tax is paid in that year. Thus under current law, the franchise tax is based on income earned in each of the next preceding years, with the exception of the franchise tax for the first California taxable year, which is a minimum tax.

Application of I.R.C. § 461(d)

Commencing Corporations with a Short First Year

Comparing the accrual dates under the pre-1961 law and current law for commencing corporations with a short initial year, the franchise tax for the first California taxable year accrues at the end of the first year under the pre-1961 statute and the current statute. Under the pre-1961 statute, the first year franchise (a minimum tax paid upon incorporation) was fixed at the end of the first year since it was based on a corporation's exercise of its franchise that year. Under current law, the first year franchise tax (also a minimum tax) accrues at the end of the first year since it is paid in that year. Accordingly, section 461(d) is not applicable.

The franchise tax for a corporation's second California taxable year accrues at different times under the pre-1961 and current law. Under pre-1961 law, the franchise tax for the second taxable year accrued in the second California year since it was based solely on the income earned in that year and since the corporation exercised its corporate franchise for that year. Under current law, the franchise tax for the second California taxable year accrues in the first year since it is based on the estimated net income earned in the first year and is paid in the first year. The reason for the different accrual dates for the second year tax relates to the different years on which the tax calculation is based and the amendment to the California statute, as interpreted by the Tax Court, which changed the time at which the liability for the franchise tax became fixed. Therefore, under the pre-1961 statute the franchise tax for the second California taxable year accrued in the second year, and not at the end of the first year. Since the current law accelerates the accrual date of a corporation's franchise tax for its second taxable year, section 461(d) applies to defer the accrual of the second year franchise tax to the year following the first income year.

Similarly, the franchise tax for a corporation's third California taxable year accrues at different times under the pre-1961 and current law. Under the pre-1961 statute, the third year franchise tax accrued in the third year, following the second income measurement year. Although based on income earned in the second California year, the third year franchise tax did not accrue in the second California year since the corporation did not exercise its corporate franchise for the third California year until the beginning of that year. Under current law, in contrast, the franchise tax for the third California taxable year accrues at the end of the second year, since the tax is based on the net income earned in the second year and is paid in the second year. Although the franchise taxes for the second and third California taxable years under pre-1961 law were based on income earned in the second year, they accrued in different years. Section 461(d) thus applies to defer the accrual of the third year franchise tax to the taxable year following the third income year.

Commencing Corporations with a Full First Year

Comparing the accrual dates for franchise taxes under the pre-1961 law and current law for commencing corporations with a first full year, it appears that the franchise tax for the first California taxable year accrues at the end of the first year under the pre-1961 statute and the current statute. Accordingly, section 461(d) is not applicable.

The franchise tax for the second California taxable year accrues at different times under each statute. Under pre-1961 law, the franchise tax for the second taxable year accrued in the second California year. Under current law, the second year tax accrues in the first California year. Since the current law accelerates the accrual date for the second year franchise tax, section 461(d) applies to defer the accrual of the tax for the second taxable year to the first day of the taxable year following the second income year (i.e. the second California year).

The franchise tax for the third taxable year also accrues at different times under each statute. Under pre-1961 law, the third year franchise tax accrued in the third California year, whereas under current law, the third year tax accrues in the second California year. Section 461(d) defers the accrual of the franchise tax for the third taxable year to the first day of the taxable year following the third income year (i.e. the third California year).

In the present case, the minimum tax for a corporation's year of commencement, required by Cal. Rev. & Tax. Code §§ 23151.1(a) and 23153, constituted taxpayer's first year franchise tax liability which it presumably paid upon incorporation. The minimum tax may be deducted in Year 1, the year of incorporation, since the tax accrues when it is due. Under the pre-1961 statute, the franchise tax liability for the taxpayer's first taxable year would also have been accruable in Year 1, since the taxpayer's first income year and first taxable year would have been the same and the taxpayer would have exercised its corporate franchise for its first California year during Year 1. Since the time at which the liability for the franchise tax for the first taxable year accrues is the same under pre-1961 and current law, section 461(d) does not apply.

As previously noted, taxpayer declared a franchise tax liability of Amount A on its first California return based on income earned in its first California year running from Date C through Date i. Taxpayer deducted this amount on its Year 1 federal return. The Amount A constitutes the franchise tax liability for its second California taxable year under current law. This amount accrues under current law on Date i, the end of taxpayer's first California year, since it is based on the net income earned in Year 1, and the tax is paid in that year. Under the pre-1961 statute, the second year franchise tax liability, also based on the net income from taxpayer's first California year, would have accrued in the following year on Date ii. Although the taxpayer's franchise tax liability for its second taxable year under pre-1961 law would have been based on the income earned in its first California year, Year 1, the

corporation would not have exercised its corporate franchise until Year 2. Since the date for accruing franchise taxes for a corporation's second taxable year is different under the pre-1961 and current law, we must determine whether section 461(d) applies. Under current law, the second year franchise tax, based on the first year's net income, accrues on Date i, whereas under pre-1961 law, the tax would have accrued the first day of the following taxable year, namely on Date ii. Because the change in law accelerated the accrual date, taxpayer's deduction of the Amount A of franchise taxes must be deferred to Date ii pursuant to section 461(d). Therefore, taxpayer may not deduct the Amount A of franchise taxes on its Year 1 return, but must deduct this amount in Year 2, the following taxable year.

Taxpayer reported a franchise tax liability of Amount B on its second California return, based on income earned in its second California year, running from Date ii through Date iii. Taxpayer deducted this amount on its Year 2 federal return. The Amount B amount constitutes taxpayer's franchise tax liability for its third taxable year under the current statute, and this amount would accrue on Date iii, since the tax is based on the net income earned in Year 2, and the tax is payable in Year 2. Under the pre-1961 statute, the franchise tax for the third taxable year would not be accruable until the first day of the following taxable year, Date iv, since it is not until then that the taxpayer would have begun to exercise its corporate franchise for its third California year. Since the current law accelerates the date for the accrual of its third year franchise tax liability, section 461(d) applies to defer the accrual of the Amount B franchise tax liability to Date iv. Accordingly, taxpayer cannot deduct the franchise tax liability of Amount B in Year 2, but must deduct it in Year 3, the subsequent taxable year.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

We recommend that you take the position that taxpayer may deduct Amount A in California franchise taxes for its second taxable year on Date ii, and Amount B in franchise taxes for its third taxable year on Date iv. The Tax Court cases of Epoch, Hitachi, as well as Revenue Ruling 79-410, firmly support this position.

Although the franchise tax accrues in the same years under pre-1961 law for short year commencing corporations and full year commencing corporations, and section 461(d) applies to defer the accrual of the franchise tax liabilities for their second and third California taxable years for the reasons explained above, Schwab reached a contrary conclusion. Schwab held that section 461(d) did not apply since the accrual dates under the pre-1961 and current law for franchise taxes based on income earned in Schwab's second California year 1988 are the same. We do not believe that the Tax Court properly compared current and prior law in deciding whether current law accelerated the accrual date for the franchise tax liability based on the income Schwab earned in its second California year pursuant to section 461(d).

In concluding that Schwab could deduct $932,979 in franchise taxes based on its second year income at the end of the second year, the Court seems to have compared the franchise tax liability for a corporation's third California taxable year under the current law to the franchise tax liability for a corporation's second California taxable year under the pre-1961 law. Although the Court correctly characterized the $932,979 amount as being based on the income Schwab earned in its second California year, 1988, this franchise tax was payable under current law for Schwab's third California taxable year, namely 1989, and not its second taxable year, 1988.

The $932,979 in franchise taxes was properly accruable at the end of 1988 under current law since it was based on the net income earned in that year and the tax was paid in that year. The franchise tax for the third taxable year could not have been deducted under pre-1961 law until the following year, 1989, since Schwab would not have exercised its corporate franchise for the third year, 1989, until the beginning of that year (even though the third year tax was determinable in the second year, 1988, since it was based on the income earned in the second year).[3] Because the accrual date for the franchise tax for a corporation's third taxable year was accelerated as a result of the amendment to California law, section 461(d) would apply to defer the accrual of the $932,979 amount from 1988 to the following year, 1989. Therefore, in analyzing whether section 461(d) applied, the accrual date for the $932,979 in franchise taxes should have been compared to the accrual date of the franchise tax for a corporation's third California taxable year under pre-1961 law since this amount represented the franchise tax payable for Schwab's third California taxable year.

Schwab can be distinguished from the present facts since it interprets the pre-1961 statute for corporations with short initial years, and is thus not controlling authority for purposes of arguing that section 461(d) applies to defer the accrual of the franchise taxes for the second and third California taxable years to the following years for the present taxpayer with an initial full year. The Schwab court specifically noted that its analysis was limited to commencing corporations with a short initial year. Schwab, 107 T.C. at 300, n. 11.

Please call (202) 622-7900 if you have any questions.

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[3] The Tax Court acknowledged that the franchise tax paid for the third taxable year would accrue under the pre-1961 law in 1989, but related the $932,979 amount throughout its opinion to the franchise tax liability for Schwab's second taxable year. Schwab, 107 T.C. at 296, 300, fn. 10.

Sincerely,
HEATHER C. MALOY
Associate Chief Counsel
(Income Tax & Accounting)
By: Gerald M. Horan
Senior Technician Reviewer
Income Tax & Accounting
Branch 1