

TAX EXEMPTION FOR NEW CORPORATIONS

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Being a new corporation in California just got less expensive. AB 10, an assembly bill which is part of the state's budget for fiscal year 1999-2000, contains a provision (Chapter 99-64) that exempts new corporations from the obligation to pay the minimum annual \$800 franchise tax for the first two years of their existence.

The Franchise Tax The franchise tax is, essentially, a fee for the privilege of corporate existence in the state of California. Corporate existence shields the shareholders, directors and officers from liability for debts and other obligations of the corporation. When the franchise fee is paid, corporate existence is recognized by the organs of the state, e.g., the courts, and the protection is given. The franchise tax is not a corporate income tax.

First Two Years Free The new law allows corporations that are incorporated January 1, 2000 or thereafter to be excused from paying the minimum \$800 franchise tax for the first two years of corporate existence. The tax is not deferred to some later time; it is excused entirely for those first two years. Additionally, unlike the current reduction of the franchise tax collectible at incorporation (and deferral of balance until filing of the tax return), this "First Two Years Are Free" rule does not require a declaration that anticipated gross receipts will be less than one million dollars; the exemption is automatically given at incorporation.

Business-Friendly State The reasoning behind the legislation was to position California as being a business-friendly state in order to encourage business owners to incorporate in California. The logic only goes so far, however; the two year exemption from paying the minimum \$800 franchise tax does not apply to limited liability companies (LLCs), even though a significant number of businesses are forming as California LLCs. The "First Two Years Are Free" rule also is not applied to limited partnerships or corporations that are reorganized solely to avoid paying the minimum franchise tax.

January 1, 2000 and After Only corporations formed on or after January 1, 2000 will qualify for the minimum \$800 franchise tax exemption. Corporations formed prior to that date will fall under the current option to either prepay the entire \$800 franchise tax at incorporation or prepay only \$300 of the minimum \$800 franchise tax, relying upon a declaration that anticipated gross receipts will be less than one million dollars for the year.

Income Tax None of this exemption applies to the corporate income tax, the tax on the net income of the corporation, which would be owed by a C Corporation or owed by the shareholders of an S Corporation. The new rule amounts to a minor loss by taxpayers in that a corporation with taxable net income that would cause a state income tax greater than \$800 would not directly pay the minimum \$800 franchise tax; it would automatically be a part of the income tax paid. An income tax to be paid of less than \$800 would require the payment of the minimum franchise tax - meaning that the corporation would pay the income tax and additionally pay an amount to bring the total up to \$800 so that the minimum franchise tax was fully paid. This payment obligation is annual - and still exists, except for corporations incorporated on or after January 1, 2000.

