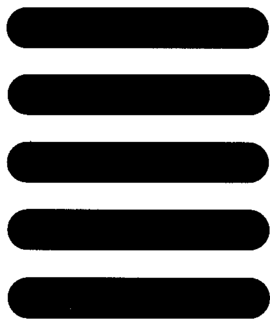

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FORMING AND LIQUIDATING SIMPLER IN CALIFORNIA

by Kathleen K. Wright • California State University, Hayward and
Robert W. Wood • San Francisco

Given California's importance as a major commercial state, and one that's involved in a huge share of M&A deals, it's doubly important to look at several new rules in this populous state. When a business is formed in California (or an out of state business qualifies) it must pay a minimum franchise tax. Even transitory subsidiaries must pay. When and how much tax is paid has become increasingly complex. Starting this year, though, when and how much to pay can be ignored for the first two years. Surprise!

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FORMING AND LIQUIDATING SIMPLER IN CALIFORNIA

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Easy In

The minimum franchise tax, a flat fee on incorporation or qualification, has fluctuated. For 1999, it was reduced from the usual $800 to $300, but only for a qualified new corporation. It remains $800 for all other entities. A qualified new corporation pays only $500 in the second year. A qualified new corporation is defined as one newly incorporated, that has not done business previously as a sole proprietorship, partnership or in any other form. Cal. Rev. & Tax Code §23153(3). It must also have gross receipts of less than $1,000,000 (including business and nonbusiness income, and even receipts of a controlled group).

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The reduced minimum franchise tax does not apply to any corporation if 50% or more of its stock is owned by another corporation, nor to limited partnerships, limited liability companies, limited liability partnerships, charitable corporations, regulated investment companies, real estate investment trusts, real estate mortgage investment conduits, financial asset securitization investment trusts and qualified subchapter S subsidiaries. Cal. Rev. & Tax. Code §23153(e)(4)

Who's On First?

California sheds no light on what is meant by "not having done business previously." Is California looking at when the business commences, or when the *active* business begins, usually a much later point? The IRS takes a broad view of pre-opening expenses under Section 195. Pre-opening expenses include all expenses incurred in anticipation of the activity becoming an active trade or business. Thus, if a restaurant incorporates in California in 2000 and has not yet opened, it is not yet operating an active business. Interviewing and hiring new employees, travel expenses, training employees, advertising, obtaining uniforms, stocking inventory, and acquiring necessary fixed assets should not disqualify it from the "discount" franchise tax during the first two years.

Lucky 2000

These considerations are no longer worrisome for incorporations that take place on or after January 1, 2000. On or after January 1, 2000 any newly formed corporation (or out of state corporation that qualifies to transact intrastate business) will be totally *exempt* from the minimum franchise tax for its first two years of operation. Cal. Rev. & Tax Code §§23153, 23221. This includes S corporations and subsidiaries of C corporations. Just to show the Golden State hasn't lost its usual arbitrary sense of humor, corporations formed under the existing rules (qualified new corporations formed on or after January 1, 1999) will still be required to pay the $500 minimum franchise tax for the second year! After the first two years the minimum franchise tax remains at $800.

Think I'm overreacting about injustice? Well, if Wally Wizard formed a qualified new corporation in 1999, he'd pay a $300 minimum franchise tax on incorporation and $500 for his first estimated payment in 1999 (Wally's prepayment for 2000). If Wally incorporated on or after January 1, 2000, he would not owe *any* minimum franchise tax in the first two years. His first payment would be $800 due for the year 2002. Go figure.

This two-free-years "millenium" exemption, like the lower minimum franchise tax allowed in 1999, does not apply to any other type of entity that is required to pay the minimum franchise tax. Thus, the following are out of luck: limited partnerships, limited liability companies, limited liability partnerships, charitable corporations, regulated investment companies, real estate investment trusts, real estate mortgage investment conduits, financial asset securitization investment trusts and qualified subchapter S subsidiaries.

While all this is good, it still includes a puzzling feature. Under Rev. and Tax Code Section 23153(f)(3) the benefit will not apply to any corporation that reorganizes solely for the purpose of avoiding payment of its minimum franchise tax.

Easy Out, Too

If a California corporation does not formally dissolve, it remains liable for the $800 minimum franchise tax, even during years when it is inactive. The process of dissolution is fraught with difficult issues. Previously, the Certificate of Dissolution (required to be filed with Secretary of State's Office) said the corporation could dissolve only if it had either paid all of its known obligations, never had any obligations or agreed to provide for personal assumption of all known obligations. "Personal assumption" required a California resident (or California corporation) to be personally liable for the debts of the dissolving corporation.

In fact, the corporation could simply state that it had paid or provided for its debts to the extent its assets permitted. Since this option did not appear on the Certificate of Dissolution, those unfamiliar with the statutory language might have allowed the company to be suspended. Suspension meant that the shareholders simply "walked away" from the company (generally after they had filed the final tax return) and stopped filing returns and paying minimum franchise tax.

In most cases, these suspended corporations were inactive, so there was little risk that the minimum franchise tax would be imposed on the shareholders (see further discussion of California's transferee liability statute below). While there was some risk in allowing a company to go suspended, the risk was substantially less than if the shareholders personally assumed the debts of the company. It sure looked sloppy, though.

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On the bright side, the Certificate of Dissolution now *permits* a company to dissolve by simply making a statement that they have paid (or provided for) all the known debts and liabilities as far as its assets permit. The form (years too late!) is now consistent with California Corporations Code Section 1905(a)(2).

A conditional dissolution can occur when the Certificate of Dissolution is filed with the Secretary of State's office, the dissolution being conditioned on the Franchise Tax Board issuing a Tax Clearance Certificate. A Tax Clearance Certificate may be obtained by filing FTB Form 3555 with the Certificate of Dissolution. The Secretary of State's office forwards the request to the Franchise Tax Board who issues a tax clearance certificate if all taxes are paid or adequately secured (Cal. Corp. Code §1905(d)).

Clean Break

If no likely suspects assume the tax, an alternative is to request a Tax Clearance Certificate on a final return/taxes paid basis. An FTB Form 3555 is attached to a copy of the final return. The FTB will issue a Tax Clearance after it has determined that all taxes have been paid.

Transferee Liability: Fears and Facts

Although the dissolution process allows shareholders, directors and officers to dissolve a company without personally assuming corporate debts, there is still no escaping liability which may be imposed under California Civil Code Sections 3439 –3439.12, California's Uniform Fraudulent Transfer Act. These provisions establish transferee liability if a transfer was made, the corporation did not receive value in exchange for the transfer and the debtor was insolvent or became insolvent as a result of the transfer. To apply, the creditor's claim must have arisen before the transfer. (Cal. Civil Code §3439.05.) Regardless of when the claim arose, if the debtor made a transfer with the intent to defraud the creditor, the transfer was not for value and was unreasonable in relation to existing debts or assets, then transferee liability can still be established. (Cal. Civil Code §3439.04).

Transferee liability is a broad remedy for creditors. Indeed, these provisions can be used by the IRS, FTB or any other claimant to pursue the shareholder if the corporation made liquidating distributions above and beyond monies owed to the shareholders for loans, sales or services rendered.

Words of Wisdom

If a corporation makes a liquidating distribution to shareholders which is not for value, that distribution can be recouped. The statute provides claimants a remedy, but the cause of action is fraught with numerous practical difficulties, such as multiple shareholders who must be found (and creditworthy) to make a lawsuit worthwhile. California's statutes on fraudulent conveyance and transferee liability should urge caution about the range of potential liability *before* assets are distributed.