Central Investment Corp. v. Commissioner, 9 T.C. 108 (1947)

A state franchise tax, even if measured by the prior year's income, accrues for federal income tax purposes in the year the privilege of doing business is exercised, not the year the income was earned or when the state tax lien attaches.

Summary

Central Investment Corp. contested the Commissioner's determination regarding the proper year to deduct California franchise taxes for federal income tax purposes. The Tax Court held that the California franchise tax, imposed for the privilege of doing business in a given year (the "taxable year"), accrues in the "taxable year," even though it is measured by the income of the preceding year (the "income year"), and even though a lien for the tax attaches on the last day of the "income year". The court reasoned the tax is for the privilege of doing business, and thus accrues when that privilege is exercised.

Facts

Central Investment Corp. was an accrual basis taxpayer. California imposed a franchise tax on corporations for the privilege of doing business in the state during a given year ("taxable year"). The tax was a percentage of the income of the preceding year ("income year"). Before 1943, the tax accrued and a lien attached on the first day of the "taxable year." A 1943 amendment stipulated that the tax accrued and a lien attached on the last day of the "income year." The company sought to deduct the 1944 franchise tax (measured by 1943 income) on its 1943 federal income tax return.

Procedural History

The Commissioner of Internal Revenue determined that the California franchise tax was deductible in 1944, not 1943. Central Investment Corp. petitioned the Tax Court for a redetermination of the tax deficiency.

Issue(s)

Whether the California franchise tax imposed for the privilege of doing business during 1944 is deductible for federal tax purposes in 1944 (the "taxable year") or in 1943 (the "income year").

Holding

No. The California franchise tax for 1944 accrued for federal tax purposes in 1944 and was deductible in that year, because the tax is for the privilege of doing business in 1944, and the liability arises only with the exercise of that privilege.

Court's Reasoning

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The court distinguished property tax cases, where liability arises from ownership on a specific date. The franchise tax, however, is an excise tax for the privilege of doing business in the "taxable year," not an income tax. The court emphasized that the tax is for the privilege of doing business, and if no business is conducted during the taxable year, the tax isn't imposed. The court stated: "the tax being for the privilege of doing business in the taxable year, the liability therefor arises only with and from the exercise of such privilege." Even though a lien attaches on the last day of the "income year," the court found this relevant only for lien priority, not federal tax accrual. The court cited *United States v. Anderson*, emphasizing that expenses should be attributed to the period when the related income is earned. The court noted IRS's consistent ruling that similar state franchise taxes are deductible in the "taxable year."

Practical Implications

This case clarifies the accrual timing for state franchise taxes, particularly when the tax is based on the prior year's income but is for the privilege of doing business in the current year. Attorneys should analyze the specific language of the state statute to determine when the *right* to do business is being taxed. The existence of a state tax lien in a prior year is not determinative for federal tax accrual purposes. This impacts tax planning for businesses operating in states with similar franchise tax structures. The case emphasizes matching the tax deduction with the period when the business activity giving rise to the tax occurred. It informs how businesses account for state franchise taxes, aligning the deduction with the year the business activity occurred, regardless of when the lien attaches.

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