# ANALYSIS OF ORIGINAL BILL

**Franchise Tax Board**

Author: Gaines | Analyst: Scott McFarlane | Bill Number: SB 556

Related Bills: None | Telephone: 845-6075 | Introduced Date: February 17, 2011

Attorney: Patrick Kusiak | Sponsor:

**SUBJECT**: Exclusion of Gain on Qualified Small Business Stock

## SUMMARY

This bill seeks to exclude from the income of noncorporate taxpayers 100 percent of gain on U.S. qualified small business stock that is acquired in 2011 and held for five years.

## RECOMMENDATION AND SUPPORTING ARGUMENTS

No position.

## SUMMARY OF SUGGESTED AMENDMENTS

Amendment one would change the language of the bill so that the bill would accomplish its apparent purpose.

## PURPOSE OF THE BILL

It appears that the purpose of the bill is to conform to the federal law that generally allows noncorporate taxpayers to exclude from income 100 percent of gain on U.S. qualified small business stock that is acquired in 2011 and held for five years.

## EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately. It appears that this bill is intended to be specifically operative with respect to stock acquired during the 2011 calendar year.

## ANALYSIS

FEDERAL/STATE LAW

### Federal Law

Gross Income in General

Gross income is the starting point in determining taxable income. Gross income is broadly defined, and generally consists of all income from all sources, such as compensation for services, business income, interest, rents, dividends, and gains from the sale of property.[1] Only items that are specifically exempt by may be excluded from gross income.

---

[1] IRC section 61.

| Board Position: | | | Executive Officer | Date |
|---|---|---|---|---|
| ______ S | ______ NA | __X__ NP | | |
| ______ SA | ______ O | ______ NAR | Selvi Stanislaus | 04/08/11 |
| ______ N | ______ OUA | | | |

Exclusion of Gain on Qualified Small Business Stock – In General

Noncorporate taxpayers may generally exclude from gross income 50 percent (60 percent for certain empowerment zone businesses) of the gain from the sale of certain small business stock acquired at original issue and held for at least five years.[2] The amount of gain eligible for the exclusion with respect to any corporation is the greater of (1) ten times the taxpayer's basis in the stock or (2) $10 million. To qualify as a small business, when the stock is issued, the gross assets of the corporation may not exceed $50 million. The corporation also must meet certain active trade or business requirements.

The portion of the gain includible in taxable income is taxed at a maximum rate of 28 percent under the regular tax.[3] A percentage of the excluded gain is an alternative minimum tax (AMT) preference;[4] the portion of the gain includible in alternative minimum taxable income is taxed at a maximum rate of 28 percent under the AMT.

Temporary Increases to Exclusion of Gain on Qualified Small Business Stock

The American Recovery and Reinvestment Act of 2009 increased the exclusion to 75 percent of eligible gain on qualified small business stock acquired after February 17, 2009, and before January 1, 2011.[5]

The Small Business Jobs Act of 2010 increased the exclusion to 100 percent of eligible gain on qualified small business stock acquired after September 27, 2010, and before January 1, 2011, and excludes the gain as an AMT preference item.[6]

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the 100-percent-gain exclusion and the AMT-preference exclusion for one year, to qualified small business stock acquired after December 31, 2011, and before January 1, 2012.[7]

---

[2] IRC section 1202.

[3] IRC section 1(h).

[4] IRC section 57(a)(7). In the case of qualified small business stock, the percentage of gain excluded from gross income that is an alternative minimum tax preference is (i) seven percent in the case of stock disposed of in a taxable year beginning before 2011; (ii) 42 percent in the case of stock acquired before January 1, 2001, and disposed of in a taxable year beginning after 2010; and (iii) 28 percent in the case of stock acquired after December 31, 2000, and disposed of in a taxable year beginning after 2010.

[5] Section 1241 of Division B of Public Law 111-5, February 17, 2009.

[6] Section 2011 of Public Law 111-240, September 27, 2010.

[7] Section 760 of Public Law 111-312, December 17, 2010.

**State Law**

California specifically does not conform to the federal exclusion for gain on qualified small business stock,[8] and instead provides its own exclusion.[9] Under California law, noncorporate taxpayers may exclude from gross income 50 percent of gain from the sale or exchange of California qualified small business stock acquired at original issue and held for more than five years. The amount of gain eligible for the exclusion with respect to any corporation is the greater of (1) ten times the taxpayer's basis in the stock or (2) $10 million.

California qualified small business stock generally means stock in a C corporation[10] that (1) has gross assets that do not exceed $50 million, (2) has at least 80 percent of its payroll attributable to employment located in California, and (3) uses at least 80 percent of the value of its assets in the active conduct of one or more qualified trades or businesses in California.

Unlike federal law, California does not apply a different tax rate to gains on qualified small business stock. However, like federal law, the exclusion is a California AMT preference item—50 percent of the excluded gain is a California AMT preference;[11] the portion of the gain includible in alternative minimum taxable income is taxed at a maximum rate of seven percent under the California AMT.

Additionally, although California has its own stand-alone exclusion, any regulation issued by the Secretary of Treasury relating federal qualified small business stock applies for California purposes to the extent that California incorporates the federal qualified-small-business-stock rules.

<u>THIS BILL</u>

This bill would have no impact because it is technically flawed.

<u>Technical Considerations</u>

This bill would conform to IRC section 1202(a)(4) as that section read on the “specified date” of January 1, 2009; however, because paragraph (4) of subsection (a) of IRC section 1202 did not exist on January 1, 2009, this bill is technically flawed. Amendment one would correct this technical error—for U.S. qualified small business stock acquired in 2011, it would generally conform to IRC section 1202 as that section was amended on December 17, 2010, by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

[8] R&TC section 18152.

[9] R&TC section 18152.5. The California exclusion generally parallels the federal exclusion under IRC section 1202, with modifications.

[10] The stock must be that of a domestic C corporation that is not a DISC or former DISC, a regulated investment company, a real estate investment trust, a real estate mortgage investment conduit, or a cooperative.

[11] R&TC section 17062(e).

## LEGISLATIVE HISTORY

None.

## ECONOMIC IMPACT

This bill would have no revenue impact due to its technical flaw.

## OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws.

A review of these states' laws found that *Illinois, Michigan* and *New York* conform to the federal amount of excludable gain on qualified small business stock. *Massachusetts* generally conforms to federal law as of January 1, 2005, thus conforms to the federal qualified-small-business-stock-gain rules as of that date, and provides its own exclusion for qualified *Massachusetts* small business stock. *Minnesota* conforms to federal law as of March 18, 2010, and conforms to the federal qualified-small-business-stock-gain rules as of that date. *Florida* imposes a corporate tax but does not impose a personal income tax; thus, a comparison to *Florida* is not relevant.

## SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

## ARGUMENTS

Pro: If corrected, this bill would conform to the federal law that generally allows noncorporate taxpayers to exclude from income 100 percent of gain on U.S. qualified small business stock that is acquired in 2011 and held for five years.

Con: This bill would not achieve its author's intended purpose due to a technical flaw.

## LEGISLATIVE STAFF CONTACT


| | |
|---|---|
| Scott McFarlane | Brian Putler |
| Legislative Analyst, FTB | Legislative Director, FTB |
| (916) 845-6075 | (916) 845-6333 |
| scott.mcfarlane@ftb.ca.gov | brian.putler@ftb.ca.gov |

| | |
|---|---|
| Analyst | Scott McFarlane |
| Telephone # | 845-6075 |
| Attorney | Patrick Kusiak |

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 556
As Introduced February 17, 2011

AMENDMENT 1

On page 2, strikeout lines 6 to 8, inclusive, and insert:

the 2011 calendar year, Section 1202 of the Internal Revenue Code, relating to partial exclusion for gain from certain small business stock, as amended by Section 760 of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111-312), shall apply, except as otherwise provided, and Section 18152.5 shall not apply.

(1) IRC sec. 1202(a)(2), relating to empowerment zone businesses, shall not apply.

(2) IRC sec. 1202(a)(3), relating to special rules for 2009 and certain periods in 2010, shall not apply.