ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author:	Wieckowski	Analyst:	Diane Deatherage	Bill Number:	AB 901
Related Bills:	See Legislative History	Telephone:	845-4783	Introduced Date:	February 22, 2013
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Qualified Small Business Stock Exclusion/50% of Gain on Sale or Exchange of Stock Held More Than 5 Years

SUMMARY

This bill would, for taxable years beginning on or after January 1, 2008, modify the terms of the exclusion and deferral of taxable gain applicable to the sale or exchange of qualified small business stock (QSBS).

RECOMMENDATION

No position.

REASON FOR THE BILL

The reason for the bill is to prevent undue hardship to taxpayers that would otherwise have been subject to taxation, interest, and penalties as a result of the decision in *Cutler v. Franchise Tax Board* (2012) 208 Cal. App. 4th 1247 (*Cutler* Decision).

EFFECTIVE/OPERATIVE DATE

As an urgency measure, this bill would be effective immediately upon enactment, and specifically applicable to each taxable year beginning on or after January 1, 2008.

ANALYSIS

FEDERAL LAW

Federal income tax law provides for the exclusion or deferral of gain from the sale or exchange of QSBS.

QSBS is defined in the Internal Revenue Code (IRC) as any stock in a qualified small business acquired by the taxpayer at the original issue date after August 10, 1993, in exchange for money or other property (not including stock), or as compensation for services provided to the corporation.

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A qualified small business is defined in the IRC as a domestic C corporation in which the aggregate gross assets of the corporation at all times since August 10, 1993, up to the time of issuance do not exceed $50,000,000. The stock must also meet certain active business requirements during substantially all of the taxpayer's holding period to be considered QSBS.

Exclusion

A taxpayer other than a corporation may exclude 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.[1] The amount of gain eligible for the exclusion by an eligible taxpayer with respect to the stock of any corporation is the greater of ten times the taxpayer's basis in the stock or $10 million.

The portion of the gain includible in taxable income is taxed at a maximum rate of 28 percent under the regular tax.[2] A percentage of the excluded gain is an alternative minimum tax preference;[3] the portion of the gain includible in alternative minimum taxable income is taxed at a maximum rate of 28 percent under the alternative minimum tax.

For qualified small business stock acquired after February 17, 2009, and before September 28, 2010, the exclusion percentage is increased to 75 percent.

For QSBS acquired after September 27, 2010, and before January 1, 2012, the exclusion percentage is increased to 100 percent and the minimum tax preference no longer applies.

The American Taxpayer Relief Act of 2012 included a provision extending the 100-percent exclusion and the exemption from minimum tax preference treatment for two years (for QSBS stock acquired before January 1, 2014).

Deferral

A taxpayer other than a corporation may elect to rollover gain from the sale of QSBS held more than six months where other QSBS is purchased during the 60-day period beginning on the date of the sale. The holding period for the replacement stock includes the period the original stock was held.

STATE LAW

California specifically does not conform to the federal exclusion or deferral of gain on qualified small business stock,[4] and instead provides its own exclusion and deferral provisions.[5]

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[1] IRC §1202.
[2] IRC §1(h).
[3] IRC §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 2013; (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 2012.
[4] R&TC §18152.
[5] R&TC §§18152.5 and 18038.5, respectively.

California QSBS Treatment Prior to the *Cutler* Decision

California allowed individual taxpayers to exclude from personal income tax 50 percent of the gain recognized on the sale of QSBS. The statute closely mirrored federal QSBS law, except that it contained three California requirements:

- When the stock was issued at least 80 percent of the corporation's payroll was attributable to employment located within California (payroll at issuance requirement);
- During substantially all of the taxpayer's holding period of the subject stock at least 80 percent of the corporation's assets was used in the active conduct of one or more qualified trades or businesses in California; and
- During substantially all of the taxpayer's holding period of the subject stock, no more than 20 percent of the corporation's payroll expense was attributable to employment located outside of California.

In *Cutler* v. *Franchise Tax Board*, the taxpayer raised the issue of the constitutionality of California's qualified small business stock provisions (R&TC sections 18152.5 and 18038.5). The trial court upheld the constitutionality of these statutes. [6] However, on appeal, the Second District Court of Appeal reversed the trial court's determination and held that because the purpose and effect of California's qualified small business stock statutes is to favor California corporations – those with property and payroll primarily within California – over their foreign competitors in raising capital among California residents, the statutes are discriminatory and cannot stand under the commerce clause of the U.S. Constitution. [7]

The Franchise Tax Board has determined that because the Court of Appeal held that R&TC sections 18152.5 and 18038.5 are unconstitutional, these sections are now invalid and unenforceable. Pursuant to the Court of Appeal's holding in *River Garden v. Franchise Tax Board*,[8] an appropriate remedy for taxable years open under the normal four-year statute of limitations for issuing assessments is to deny the exclusion/deferral to taxpayers who benefited from either the exclusion/deferral.

THIS BILL

This bill would repeal and reenact the QSBS provisions with the exception of the "California only" requirements; thereby resolving the constitutional conflict by extending them to taxpayers, for taxable years beginning on or after January 1, 2008, without regard to the geographical limitation to California.

This bill would also repeal and reenact the existing QSBS language that relates to the gain deferral.

The bill would make an appropriation from the General Fund of an amount sufficient to make the refunds required pursuant to the changes in the law made by this act, including by providing for the waiver of interest and penalties.

[6] *Cutler* v. *Franchise Tax Board,* Super. Ct. L.A. County, 2012, No. BC421864.
[7] *Cutler v. Franchise Tax Board* (2012) 208 Cal. App. 4th 1247.
[8] *River Garden Retirement Home* v. *Franchise Tax Board* (2010) 186 Cal. App. 4th 922.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would not significantly impact the department's programs and operations.

LEGISLATIVE HISTORY

SB 209 (Lieu, 2013/2014) would provide that gross income does not include 50 percent of any gain from the sale or exchange of QSBS held for more than 5 years, for taxable years beginning on or after January 1, 2008, and before January 1, 2013, and also for taxable years beginning on or after January 1, 2016. Although the California requirements for business activity (assets and payroll) were eliminated from the existing QSBS statute, the language still retains the 80 percent California payroll requirement at the time of stock issuance. SB 209 is pending before the Senate Committee on Governance and Finance.

AB 1203 (Gorell, 2013/2014) would waive interest and penalties assessed on additional tax that is owed due to a court holding a statute as unconstitutional. AB 1203 is pending before the Assembly Revenue and Taxation Committee.

SB 556 (Gaines, 2011/2012) would have excluded from the income of noncorporate taxpayers 100 percent of gain on U.S. QSBS that was acquired in 2011 and held for five years. SB 556 failed to pass out of the Senate Committee on Governance and Finance.

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 in most respects to federal law as of January 23, 2013, 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.

FISCAL IMPACT

This bill would require changes to existing tax forms and instructions and information systems. As a result, this bill would impact the department's printing, processing and information technology costs. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

	Estimated Revenue Impact of AB901 As Introduced February 22, 2013 For Taxable Years Beginning On or After January 1, 2008 Assumed Enactment After June 30, 2013 ($ in Millions)			
	2012-13	2013-14	2014-15	2015-16
Loss due to allowing exclusion to taxpayers who have not already claimed the QSBS exclusion between 2008 and 2012*	- $45.0	- $39.0	- $5.2	- $1.0
Loss due to not issuing Assessments (NPAs) for tax years 2008 through 2011	- $7.8	- $3.0	- $3.0	- $24.0
Loss of Interest owed on Assessments (NPAs) for tax years 2008 through 2011	- $0.8	- $0.3	- $0.5	- $5.2
Loss due to allowing exclusion to all taxpayers regardless of geography for 2013 and beyond	N/A	- $50.0	- $50.0	- $55.0
Total	- $53.6	- $92.3	- $58.7	- $85.2

* This estimate includes those taxpayers who did not claim the exclusion for the 2008-2011 tax years and all taxpayers for the 2012 tax year.

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

LEGAL IMPACT

The existing language limits the QSBS provisions to domestic corporations as defined under federal law. The federal definition of domestic means created or organized in the United States. The language in the bill may be found unconstitutional as the QSBS treatment is limited to qualified stock in the United States. In *Kraft General Foods, Inc*. v. Iowa Department of Revenue, 505 US 71, 112 S. Ct. 2365 (1992), the United States Supreme Court held that states cannot discriminate against foreign dividends, even if the state is simply conforming to federal tax law. The court determined that, even if the federal government may discriminate in favor of domestic commerce, individual states cannot discriminate.

If this bill is enacted after the statute of limitations for filing a claim for refund for taxable year 2008 has closed, the remedy will be incomplete and arguably defective as it will be unable to satisfy the requirement for treating similarly situated taxpayers in the same manner.[9] To resolve this issue, the author may wish to amend the bill to add language that opens up the statute of limitations for filing a claim for refund until 180 days after the effective date of the bill.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some could argue that this bill would prevent undue hardship retroactively to taxpayers that would otherwise have been subject to taxation, interest, and penalties based on a court decision.

Opponents: Some taxpayers may say that with the state's current fragile economy, providing a tax incentive to a California taxpayer that invests in a small business should be avoided.

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[9] *McKesson Corp. v. Florida Alcohol & Tobacco Div.* (1990) 496 U.S. 18, 31 found that if a statute that confers a benefit is found constitutionally discriminatory, a court is required to accord the party discriminated against meaningful backward-looking relief to rectify the unconstitutional deprivation.