ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author:	Walters	Analyst:	Diane Deatherage	Bill Number:	SB 1386
Related Bills:	See Legislative History	Telephone:	845-4783	Introduced Date:	February 21, 2014
		Attorney:	Bruce Langston	Sponsor:	

SUBJECT: Qualified Small Business Stock Exclusion / Delete Repeal Date

SUMMARY

This bill would modify the terms of the exclusion and deferral of taxable gain, under the Personal Income Tax Law, 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 modify provisions applicable to the sale or exchange of QSBS, to allow a taxpayer to exclude or defer a portion of the taxable gain of QSBS from income.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and specifically operative for sales, including installment sales, occurring in taxable years beginning on or after January 1, 2015.

ANALYSIS

FEDERAL

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.

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 million. The stock must also meet certain active business requirements during substantially all of the taxpayer's holding period to be considered QSBS.

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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 QSBS 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, 2014, the exclusion percentage is increased to 100 percent and the minimum tax preference no longer applies.

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 (replacement stock) 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 QSBS,[4] and instead provides its own exclusion and deferral provisions.[5]

California QSBS Treatment Prior to the *Cutler* Decision[6]

California allowed noncorporate taxpayers to exclude from income 50 percent of the gain recognized on the sale of QSBS, and allowed such taxpayers to defer the gain from the sale of QSBS held more than six months where other QSBS (replacement stock) was purchased within

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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 and 18038.4, respectively.
[5] R&TC §§18152.5 and 18038.5, respectively.
[6] *Cutler v. Franchise Tax Board* (2012) 208 Cal. App. 4th 1247.

the 60-day period beginning on the date of the sale. The state statutes closely mirrored federal QSBS law, except for the following 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.

Constitutionality Issue

In *Cutler v. Franchise Tax Board*,[7] the taxpayer raised the issue of the constitutionality of California's QSBS provisions (Revenue & Taxation Code (R&TC) sections 18152.5 and 18038.5). The trial court upheld the constitutionality of these statutes. 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 QSBS 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.

California QSBS Treatment after the *Cutler* Decision

As explained in FTB Notice 2012-03,[8] the Franchise Tax Board (FTB) has determined that because the Court of Appeal held that R&TC sections 18152.5 and 18038.5 are unconstitutional, these sections are invalid and unenforceable, and pursuant to the Court of Appeal's holding in *River Garden v. Franchise Tax Board*,[9] an appropriate remedy for taxable years open under the normal four-year statute of limitations for issuing assessments is to deny the exclusion or deferral to taxpayers who benefited from either the exclusion or the deferral, or both.

California QSBS Treatment After AB 1412 (Chapter 546 of the Statutes of 2013)

Exclusion Provision

The QSBS exclusion provision was amended to:

- Allow taxpayers to exclude 50 percent of the gain from the sale or exchange of their QSBS for taxable years beginning on or after January 1, 2008, and before January 1, 2013. In effect, this applies the QSBS treatment prior to the *Cutler* decision to gains from the sales or exchange for taxable years beginning on or after January 1, 2008, and before January 1, 2013.

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[7] *Cutler v. Franchise Tax Board,* Super. Ct. L.A. County, 2012, No. BC421864.
[8] FTB Notice 2012-03, dated December 21, 2012.
[9] *River Garden Retirement Home v. Franchise Tax Board* (2010) 186 Cal. App. 4th 922.

- Allow taxpayers to exclude 50 percent of the gain included in installment payments received, or that will be received, in taxable years beginning on or after January 1, 2008, for sales of QSBS made in taxable years beginning before January 1, 2013.
- Revise the definition of qualified small business to mean a domestic C corporation that meets the following:
  - The aggregate gross assets of the corporation (or its predecessor) at all times on or after July 1, 1993, and before the issuance of the stock, did not exceed $50 million;
  - The aggregate gross assets of the corporation immediately after the issuance did not exceed $50 million;
  - At least 80 percent of the corporation’s payroll is attributable to employment located within California (at time of stock issuance); and
  - The corporation agrees to submit reports to the FTB and shareholders to carry out the purposes of the QSBS statute.
- Remove the former limitations that 80 percent of the corporation’s assets used in the conduct of its business must have been in California, as well as no more than 20 percent of the corporation's payroll was attributable to employment located outside of California during substantially all of the taxpayer's holding period of the subject stock, but retains the exclusion provision that at least 80 percent of the corporation's payroll is attributable to employment located within California (at the time of stock issuance).

Deferral Provision

The deferral provision was amended to:

- Apply to sales after August 5, 1997, and before January 1, 2013. As a result, the deferral provision is inoperative as of January 1, 2013.
- Prohibit the FTB's accrual of interest and imposition of any penalty on the additional tax due as defined in this bill.

Relief Provision

A relief provision was added to:

- Require that the FTB enter into a written installment payment agreement with the taxpayer, upon request, for up to five years, for the payment of additional tax due.
- Provide that the interest, penalty, and installment agreement provisions would be retained if the QSBS exclusion were held to be invalid, ineffective, or unconstitutional by a court of competent jurisdiction.
- Extend the statute of limitations for filing a QSBS claim for refund for taxable years beginning on or after January 1, 2008, and ending before January 1, 2009.

The exclusion and deferral provisions cease to be operative for taxable years beginning on or after January 1, 2013.

Non-severability Clause

Additionally, off-code language specified that the provisions of the new exclusion and deferral are not severable so that if any aspect was held invalid, the remaining provisions would also be invalid.

The QSBS provisions will be repealed by their own terms, unless extended before the repeal date by a later enacted statute as follows:

- Gain exclusion provision would be repealed on January 1, 2016;
- Gain deferral provision would be repealed on January 1, 2016; and
- Relief provision (interest, penalty, and the installment agreement) would be repealed on January 1, 2018.

THIS BILL

Exclusion Provision

This bill would remove the repeal date for the existing exclusion provision.

This bill would add a new provision that would reinstate the 50 percent exclusion treatment of QSBS that would apply to sales, including installment sales, occurring in taxable years beginning on or after January 1, 2015.

Deferral Provision

This bill would remove the repeal date of the existing deferral provision.

The bill would also add a new provision for deferral that would apply to QSBS sales, including installment sales, occurring in taxable years beginning on and after January 1, 2015.

TECHNICAL CONSIDERATIONS

As a result of the addition of the phrase “one of the following” to the specifications applicable to “any future qualified trade or business”, any such trade or business that met more than one of the specifications would fail to qualify for QSBS treatment. If this is contrary to the author’s intent, it is suggested that the phrase “one of the following” on page 7 and page 16 be amended to read, “one or more of the following.”

LEGISLATIVE HISTORY

AB 1412 (Bocanegra, et al., Chapter 546, Statutes of 2013) modified the QSBS provisions to allow taxpayers to exclude 50 percent of the gain from the sale or exchange of their QSBS for taxable years beginning on or after January 1, 2008, and before January 1, 2013. It also amended the deferral provision to apply to sales after August 5, 1997, and before January 1, 2013.

SB 209 (Lieu, et al., Chapter 543, Statutes of 2013) was nearly identical to AB 1412, except the gain exclusion was 38 percent. Because AB 1412 was chaptered subsequent to SB 209, AB 1412 chaptered out the provisions in SB 209.

AB 901 (Wieckowski, 2013/2014) would have 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 QSBS. AB 901 failed to pass out of the Assembly Revenue and Taxation Committee.

AB 1203 (Gorell, 2013/2014) would have prohibited the FTB's accrual of interest and imposition of penalties assessed on additional tax that is owed due to a court holding a statute as unconstitutional. AB 1203 failed to pass out of 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 QSBS. *Massachusetts* generally conforms to federal law as of January 1, 2005, thus conforming to the federal QSBS gain rules as of that date, but 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 QSBS 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

The department's costs to implement this bill have yet to be determined. As the bill moves through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of SB 1386 As Introduced on February 21, 2014 Assumed Enactment After June 30, 2014 ($ in Millions)		
2014-15	2015-16	2016-17
- $21	- $38	- $39

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

LEGAL IMPACT

Because the existing QSBS tax treatment was challenged and held unconstitutional by the Court of Appeal due to the presence of in-state payroll and property requirements, a similar challenge could be made regarding this new statute. While there are differences between this new statute and the statute invalidated by the Court of Appeal, a Court of Appeal may determine that this bill's 80 percent California payroll limitation under the definition of qualified small business is discriminatory.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some could argue that this bill would incentivize investors to invest in small businesses and thereby promote the growth of the economy.

Opponents: Some could argue that preferential treatment of losses from the sale of QSBS would have more of an incentivizing effect because the majority of small and start up businesses fail within the first five years.

POLICY CONCERNS

Existing law specifies that the provisions of the new exclusion and deferral are not severable so that if any aspect is held invalid, the remaining provisions would also be invalid. This bill lacks similar language and should be considered.

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