Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Lieu, et al.	Analyst:	Diane Deatherage	Bill Number:	SB 209
Related Bills:	See Legislative History	Telephone:	845-4783	Amended Date:	April 3, 2013
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Qualified Small Business Stock Exclusion or Deferral

SUMMARY

This bill would 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.

Summary of Amendments

The April 3, 2013, amendments removed provisions of the bill related to the vehicle license fee, and replaced them with the provisions discussed in this analysis. This is the department's first analysis of the bill. This analysis only addresses the provisions of this bill that impact the department's programs and operations.

Summary of Suggested Amendments

Amendment 1 would add clarifying language to further define the term "qualified small business stock."

Amendments 2 and 3 would correct inaccurate references to the Internal Revenue Code (IRC).

Amendments 4 and 5 would add a severability clause to each section in the event any provision of this bill if enacted is held to be invalid or unconstitutional.

REASON FOR THE BILL

The reasons for the bill are 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*[1] and, after January 1, 2016, to preserve the incentive to invest in California start-up ventures to the extent possible.

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[1] *Cutler v. Franchise Tax Board,* (2012) 208 Cal. App. 4th 1247.

Board Position:			Executive Officer	Date
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EFFECTIVE/OPERATIVE DATE

If enacted in the 2013 legislative session, this bill would be effective January 1, 2014.

The deferral provision of this bill would be specifically operative for sales made after August 5, 1997, and before January 1, 2013, and to sales made on and after January 1, 2016.

The amended exclusion provision of this bill would be specifically operative for taxable years beginning on or after January 1, 2008, and before January 1, 2013, and repealed January 1, 2016.

The new exclusion provision would be operative for taxable years beginning on or after January 1, 2016.

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 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 $50,000,000. The stock must also meet certain active business requirements during substantially all of the taxpayer's holding period to be considered qualified small business stock.

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.[2] 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.[3] A percentage of the excluded gain is an alternative minimum tax preference;[4] 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.

[2] IRC §1202.
[3] IRC §1(h).
[4] 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.

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,[5] and instead provides its own exclusion and deferral provisions.[6]

California QSBS Treatment Prior to the *Cutler* Decision

California allowed individual taxpayers to exclude from income 50 percent of the gain recognized on the sale of QSBS. The statute 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.

In *Cutler* v. *Franchise Tax Board*,[7] the taxpayer raised the issue of the constitutionality of California's QSBS provisions (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.

[5] R&TC §§18152 and 18038.4, respectively.
[6] R&TC §§18152.5 and 18038.5, respectively.
[7] *Cutler* v. *Franchise Tax Board,* Super. Ct. L.A. County, 2012, No. BC421864.

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 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.

Installment Sales

With the exception of trades occurring on an established securities market, a taxpayer may elect to report the disposition of QSBS using the installment method.[9]

California conforms by reference to the federal installment sales statutes.[10] The installment method applies unless the taxpayer affirmatively elects out of the installment method.[11] It is well settled that installment payments are subject to taxation under the provisions of the law in effect at the time the gain is recognized.[12] A risk of reporting gain using the installment method is the possibility that the tax law might change not only as to "tax rate but in any other of its provisions."[13]

An election out of installment sale treatment must be made by the due date of the return.[14] A taxpayer may make a late election out of the installment method only "in those rare circumstances when the Internal Revenue Service concludes that the taxpayer had good cause for failing to make a timely election."[15]

THIS BILL

Deferral Provision

This bill would modify the QSBS deferral provision to apply to sales after August 5, 1997, and before January 1, 2013, and to sales made on or after January 1, 2016.

Exclusion Provisions

The bill would (1) modify and repeal existing law (amended exclusion) to allow the QSBS exclusion to taxpayers for taxable years beginning on or after January 1, 2008, and before January 1, 2013, and (2) add a new provision allowing a QSBS exclusion for taxable years beginning on or after January 1, 2016; therefore, the exclusion provisions would not apply to taxable years beginning on or after January 1, 2013, and before January 1, 2016.

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8 *River Garden Retirement Home* v. *Franchise Tax Board* (2010) 186 Cal. App. 4th 922.
9 IRC § 453(k)(2).
10 R&TC §§ 17551 and 17560.
11 IRC § 453(d).
12 *Snell* v. *Commissioner* (5th Cir. 1938) 97 F.2d 891.
13 *Snell* v. *Commissioner*, supra at 893.
14 IRC § 453(d)(2).
15 Treas. Reg. § 15a.453-1(d)(3)(ii).

Under both of these provisions, the definition of qualified small business would mean any domestic C corporation if all of the following apply:

- The aggregate gross assets of the corporation (or its predecessor) at all times on or after July 1, 1993, and before the issuance 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 the 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.

As modified, the amended exclusion provision would eliminate the former limitations that 80 percent of the corporation's assets used in the conduct of its business must be 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.

Existing law contains the definition of QSBS that requires that the stock must have been originally issued after August 10, 1993. For taxable years beginning on and after January 1, 2016, the new provision that would be added by the bill would revise the QSBS definition to mean stock originally issued after August 10, 1993, and before January 1, 2013, or issued after January 1, 2016.

Neither provision would be operative for taxable years beginning on or after January 1, 2013, and before January 1, 2016. Therefore, the exclusion of gain recognized on the sale of QSBS would be unavailable for sales made during this period. In addition, any stock acquired during this period would not be eligible for QSBS treatment under the new provision that would be added by the bill. Finally, the bill's provisions regarding the receipt of non-QSBS in a transaction whereby gain is not required to be currently recognized (commonly a tax-free reorganization) would appear to be non-operative during this period.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

A taxpayer could avoid receiving taxable gain on the sale of QSBS during the period that 100 percent of the gain would be taxable (taxable years beginning on or after January 1, 2013, and before January 1, 2016) by electing to report the gain using the installment method and scheduling the installment payments to avoid receiving payments when the gain exclusion is unavailable. In addition, a taxpayer that sold QSBS prior to January 1, 2013, and elects to report the gain using the installment method and receives scheduled installment payments during the period that 100 percent of the gain would be taxable, would be precluded from excluding 50 percent of the gain. If this is contrary to the author's intent, this bill should be amended.

Because the determination of whether a corporation is a qualifying small business would be made as of the date the stock is acquired by a taxpayer, a corporation that is formed in California and relocates outside of the state one day after the taxpayer's stock purchase would meet the requirements for the stock to be QSBS for that taxpayer. If this is contrary to the author's intent, this bill should be amended.

TECHNICAL CONSIDERATIONS

R&TC section 18152.5(e)(1)(C) contains two references to Section 41(b)(4) of the IRC that should be amended to refer to Section 41(b)(2) of the IRC describing in-house research expenses. Amendments 2 and 3 correcting the references are provided.

LEGISLATIVE HISTORY

AB 901 (Wieckowski, 2013/2014) 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 QSBS. AB 901 is pending before the Assembly Revenue and Taxation Committee.

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 QSBS. *Massachusetts* generally conforms to federal law as of January 1, 2005, thus conforms to the federal QSBS 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 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

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

Table 1	Estimated Revenue Impact of SB 209 As Amended on April 3, 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*	- $38.0	- $33.0	- $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
Total	- $44.6	- $34.3	- $8.7	- $30.2

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

Table 2	Estimated Revenue Impact of SB 209 As Amended on April 3, 2013 For Taxable Years Beginning On or After January 1, 2016 Assumed Enactment After June 30, 2013 ($ in Millions)			
	2015-16	2016-17	2017-18	2018-19
Loss due to allowing exclusion to taxpayers that meet the payroll limitation for 2016 and beyond	- $28.0	- $46.0	- $44.0	- $43.0

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

LEGAL IMPACT

The California Constitution requires a state agency to enforce a statute without regard to the issue of constitutionality until an appellate court determines the statute unconstitutional.[16]

[16] Cal. Const. Art. III § 3.5.

As explained in FTB Notice 2012-03, the FTB has determined that because the Court of Appeal held that the QSBS provisions under current law are unconstitutional, these sections are now invalid and unenforceable.

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, it is likely that a similar challenge will 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. Therefore, it may be prudent to include language regarding the severability of this new statute in order to provide clarity as to the Legislature’s intent if the new statute is determined by an appellate court to be unconstitutional. Alternative amendments (amendments 4 and 5) addressing severability are provided.

Given the recent decision of the appellate court in *Cutler v. Franchise Tax Board,* if the bill is enacted and subsequently invalidated by an appellate court, there would be an increased risk of a court assessing attorneys' fees against the FTB.

The existing bill language would limit 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 United States corporations. 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 for the unconstitutionality found to exist by the Court of Appeal would be incomplete and arguably defective as it will be unable to satisfy the requirement for treating similarly situated taxpayers in the same manner.[17] To resolve this issue, the author may wish to amend the bill to add language. For example, the author may wish 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.

[17] *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.

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 could say that with the state's fragile economy, expansion of a tax incentive giving preferential treatment to a taxpayer that invests in a small business should be avoided.

LEGISLATIVE STAFF CONTACT

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 209
AS AMENDED ON APRIL 3, 2013

AMENDMENT 1

On page 13, line 18, after "before January 1, 2013, or" insert:

"originally"

AMENDMENT 2

On page 6, line 28, after "Section" strikeout "41(b)(4)", inclusive, and insert:

"41(b)(2)"

AMENDMENT 3

On page 16, line 2, after "Section" strikeout "41(b)(4)", inclusive, and insert:

"41(b)(2)"

AMENDMENT 4

On page 12, after line 17, insert:

<u>(o) The provisions of this section are severable. If any provision of this section and its application is held invalid, that invalidity shall not affect other provisions or applications of this section that can be given effect without the invalid provision or application, and to this end the provisions of this section are severable.</u>

OR

<u>(o) The provisions of this section are not severable. If any provision of this section and its application is held invalid, that invalidity shall apply to the entire section.</u>

AMENDMENT 5

On page 21, after line 16, insert:

<u>(n) The provisions of this section are severable. If any provision of this section and its application is held invalid, that invalidity shall not affect other provisions or applications of this section that can be given effect without the invalid provision or application, and to this end the provisions of this section are severable.</u>

OR

<u>(n) The provisions of this section are not severable. If any provision of this section or its application is held invalid, that invalidity shall apply to the entire section.</u>