

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: May 24, 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 May 24, 2013, amendments would:

- Decrease the percentage of excludable gain on the sale or exchange of QSBS.
- Modify the operative dates of the deferral and exclusion provisions.
- Waive interest and penalties on the additional tax due as a result of the application of the *Cutler*¹ decision.
- Authorize a taxpayer to enter into an installment payment agreement for the payment of additional tax due as a result of the application of the *Cutler* decision.
- Include language that appropriates amounts necessary to make the payments required under the bill.
- Remove previously proposed language to add a new Revenue and Taxation Code (R&TC) section for a QSBS exclusion/deferral for taxable years beginning on or after January 1, 2016.
- Add severability language.
- Make nonsubstantive, technical changes.

The May 24, 2013, amendments resolved the technical consideration and one of the implementation considerations as discussed in the department’s analysis of the bill as amended April 3, 2013. As a result of the May 24, 2013, amendments, the previously provided revenue estimate has been changed and the department has identified additional implementation and technical considerations. This analysis replaces the department's prior analysis of the bill as amended April 3, 2013.

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

| | | |
|-----------------|-------------------|---------------|
| Board Position: | Executive Officer | Date |
| _____ S | _____ NA | <u> X </u> NP |
| _____ SA | _____ O | _____ NAR |
| _____ N | _____ OUA | |
| | Selvi Stanislaus | 7/31/13 |

Summary of Suggested Amendments

Amendment 1 would add repealing language for the deferral and relief provisions.

Amendment 2 would define additional tax relating to interest accrual and penalty imposition, clarify administrative details relating to the installment payment agreement, specify the type of court of competent jurisdiction that may hold the statute invalid, ineffective, or unconstitutional, and provide repeal language.

Amendment 3 would clarify the remedy in the event that the retroactive QSBS exclusion provision is ruled to be discriminatory and overturned.

REASON FOR THE BILL

The reason for the bill is to address the retroactive collection of taxes from 2,500 small business investors.

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.

The 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 would be repealed by its own terms on January 1, 2016, unless a later enacted statute, that is enacted before January 1, 2016, deletes or extends that date.

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.

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.

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.

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 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 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);

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.

⁵ R&TC §§18152 and 18038.4, respectively.

⁶ R&TC §§18152.5 and 18038.5, respectively.

- 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.

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 now invalid and unenforceable. 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.

THIS BILL

Deferral Provision

This bill would amend R&TC section 18038.5 to apply to sales after August 5, 1997, and before January 1, 2013. As a result, the deferral provision would be inoperative as of January 1, 2013.

Exclusion Provisions

The bill would allow taxpayers to exclude 38 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. As a result, affected taxpayers would remain liable for a portion of the additional tax on the sale or exchange of their QSBS gain computed after the *Cutler* decision. For example, a taxpayer originally calculated a \$20,000 QSBS gain in taxable year 2008. For California tax purposes, the taxpayer correctly reported a QSBS gain of \$10,000 (50 percent of \$20,000 total gain would be excluded from gross income) on a timely filed tax return. After the *Cutler* decision, the taxpayer would be unable to exclude any portion of the gain from gross income and the previously excluded \$10,000 gain would be taxable. If this bill is enacted, additional tax would be computed on \$2,400 of the gain (38 percent of \$20,000 would be excluded from income and therefore 62 percent of the total gain would be included in gross income – of which 50 percent, \$10,000, had been included in gross income).

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.

Under this bill, the definition of qualified small business would 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.

The bill would eliminate 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 would retain 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).

Neither provision (deferral or exclusion) would be operative for taxable years beginning on or after January 1, 2013. The deferral and exclusion provisions would cease to be operative for taxable years beginning on or after January 1, 2013, and the exclusion provision would be repealed by its own terms as of January 1, 2016, unless a later enacted statute deletes or extends this date.

In addition, this bill would:

- Waive interest and penalties on the additional tax due as a result of the application of the *Cutler* decision.
- Authorize a taxpayer to enter into a written installment payment agreement with the FTB, for up to five years, for the payment of additional tax due as a result of the application of the *Cutler* decision.
- Make a continuous appropriation from the General Fund in the amounts necessary to make payments as required under this bill.
- Add severability language that would, upon a provision or application of a provision being invalidated by a court, allow the remaining provisions to remain in effect.
- Provide that the interest and penalty waiver 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.

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.

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.

The FTB would be required to waive interest and penalties on taxes assessed as a result of the *Cutler* decision for each taxable year beginning on or after January 1, 2008, and before January 1, 2013. If the author intends for interest and penalties to be waived for a specified period rather than indefinitely, this bill should be amended.

This bill would require that the FTB enter into a written installment payment agreement for a period of up to five years upon the request by a taxpayer for the payment of any additional taxes due as a result of the *Cutler* decision. Amendment 2 contains language to clarify this requirement.

TECHNICAL CONSIDERATIONS

The bill provides a repeal date for the exclusion provision (R&TC section 18152.5), but no repeal dates are included for the deferral provision (R&TC section 18038.5) or the added provision (R&TC section 18153) relating to interest and penalties, installment agreements, and severability language. Amendments 1 and 2 are suggested to automatically repeal these provisions when they become obsolete.

R&TC section 18153(b) would include the phrase "court of competent jurisdiction" when describing the level of court whose holding would be binding on a state agency if it holds that R&TC section 18152.5 is invalid, ineffective, or unconstitutional. 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;¹⁰ therefore, it is suggested to clarify the phrase to conform with the California Constitution. Language contained in Amendment 2 is suggested to modify the undefined phrase "court of competent jurisdiction" for consistency and to harmonize it with the term used in the California Constitution.

¹⁰ Cal. Const. Art. III § 3.5.

This bill uses phrases that are unclear and inconsistent, i.e., "taxes assessed" and "taxes due" in R&TC section 18153(a) on page 21 lines 30 and 36, respectively. The absence of clarity and consistency of these phrases could lead to disputes with taxpayers and would complicate the administration of this provision. Language contained in Amendment 2 would replace the above phrases with "additional tax" and also clearly define "additional tax" for various purposes.

To clarify the outcome of the effect upon the exclusion provision if it is found by a court of competent appellate jurisdiction to be invalid, ineffective, or unconstitutional, the author may wish to amend the severability clause language. Severability clauses preserve the remaining portions of a provision if a portion of it is invalidated by a court. If it is specified that the provision is not severable, the complete provision would be unenforceable if any aspect of it is invalidated by a court. Amendment 3 would clarify that the entire QSBS exclusion provision (R&TC section 18152.5) would be unenforceable if a portion of that provision (for example, the California payroll at issuance requirement) were to be found unconstitutional by a competent appellate jurisdiction.

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 currently in 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 currently in 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

Staff will need to change existing tax forms and instructions and implement a manual process for waiving interest and penalties on additional tax specifically assessed as a result of the *Cutler* decision. This bill includes language to continuously appropriate amounts from the General Fund for the FTB to make the payments required by the bill.

ECONOMIC IMPACT

Revenue Estimate

| Estimated Revenue Impact of SB 209 As Amended May 24, 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 38 percent exclusion to taxpayers who have not already claimed the QSBS exclusion between 2008 and 2012* | - \$21.0 | - \$18.0 | - \$2.0 | - \$0.3 |
| Loss due to issuing limited assessments for tax years 2008 through 2011 | - \$16.0 | - \$12.0 | - \$12.0 | - \$12.0 |
| Loss due to waiving interest owed on assessments for tax years 2008 through 2011 | - \$2.2 | - \$1.5 | - \$1.6 | - \$1.5 |
| Total ** | - \$39.2 | - \$31.5 | - \$15.6 | - \$13.8 |

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

** Additional revenue losses in subsequent fiscal years are as follows: - \$7.9 million in Fiscal Year (FY) 2016-17, - \$2.4 million in FY 2017-18, and - \$600,000 in FY 2018-19.

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

LEGAL IMPACT

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 would be unable to satisfy the requirement for treating similarly situated taxpayers in the same manner.¹¹ 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 this bill.

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.¹²

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 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. 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. Amendment 3 addressing severability is 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.

SUPPORT/OPPOSITION

Support: Bay Area Council; California Business Defense; California Healthcare Institute; TechAmerica; Silicon Valley Leadership Group.¹³

Opposition: None received.

¹¹ *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.

¹² Cal. Const. Art. III § 3.5.

¹³ From Senate Governance and Finance Committee Analysis dated April 25, 2013.

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 economic recovery, expansion of a tax incentive giving preferential treatment to a taxpayer that invests in a small business should be avoided.

LEGISLATIVE STAFF CONTACT

Diane Deatherage

Legislative Analyst, FTB

(916) 845-4783

diane.deatherage@ftb.ca.gov

Mandy Hayes

Revenue Manager, FTB

(916) 845-5125

mandy.hayes@ftb.ca.gov

Gail Hall

Legislative Director, FTB

(916) 845-6333

gail.hall@ftb.ca.gov

| | |
|-------------|------------------|
| Analyst | Diane Deatherage |
| Telephone # | (916) 845-4783 |
| Attorney | Patrick Kusiak |

**PROPOSED AMENDMENTS TO SB 209
AS AMENDED ON MAY 24, 2013**

AMENDMENT 1

On page 3, at the end of line 20, insert:

This section shall remain in effect only until January 1, 2016, and as of that date is repealed.

AMENDMENT 2

On page 21, strikeout lines 29 through 38, inclusive, and on page 22, strikeout lines 1 through 11, inclusive, and insert:

18153 (a) In the case of a taxpayer subject to tax under Part 10 (commencing with Section 17001):

- (1) No penalty shall be imposed with respect to the additional tax of that taxpayer.
- (2) No interest shall accrue with respect to the additional tax of that taxpayer due for the taxable year.
- (3) In the case of a liability for additional tax of a taxpayer under Part 10 (commencing with Section 17001), notwithstanding any other eligibility requirements contained in Section 19008, the Franchise Tax Board shall enter into an agreement under Section 19008 to accept the full payment of the additional tax in installments over a period not to exceed five years.

(b) For purposes of subdivision (a), the term "additional tax" means:

- (1) The increase in tax for a taxable year beginning on or after January 1, 2008, and before January 1, 2013, to the extent that the increase is attributable to the amendments made to Section 18152.5 by the act adding this section.
- (2) If Section 18152.5, as amended by the act adding this section, is for any reason held invalid, ineffective, or unconstitutional by a an appellate court of competent jurisdiction, the term "additional tax" means the increase in tax for a taxable year beginning on or after January 1, 2008, and before January 1, 2013, to the extent that the increase is attributable to the implementation of the appellate court holding invalidating Section 18152.5, as amended by the act adding this section, coupled with the implementation of the decision of the California Court of Appeal, *Frank Cutler v. Franchise Tax Board*, (2012) 208 Cal. App. 4th 1247, as announced in Franchise Tax Board Notice 2012-03, dated December 21, 2012.

(c) This section shall remain in effect only until January 1, 2018, and as of that date is repealed.

AMENDMENT 3

On page 22, ~~strikeout~~ lines 19 through 22, inclusive, and insert:

SEC. 5. The provisions of Section 18152.5, as amended by the act adding this section, are not severable. If any provision of Section 18152.5, as amended by the act adding this section, or its application is held invalid, that invalidity shall apply to the entire section.