

## BILL ANALYSIS

Department, Board, Or Commission	Author	Bill Number/Version Date
<b>Franchise Tax Board</b>	Lieu, et al.	<b>SB 209 (E-09/12/13)</b>

### 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).

### 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.

#### Deferral Provision

The deferral provision of this bill would be specifically operative for sales made after August 5, 1997, and before January 1, 2013. This provision would remain in effect only until January 1, 2016, and as of that date would be repealed, unless a later enacted statute, that is enacted before January 1, 2016, deletes or extends that date.

#### Exclusion Provision

The exclusion provision of this bill would be specifically operative for:

- Sales, including installment sales, occurring in taxable years beginning on or after January 1, 2008, and before January 1, 2013; and
- Installment payments received in taxable years beginning on or after January 1, 2008, for sales of QSBS made in taxable years beginning before January 1, 2013.

This provision would remain in effect only until January 1, 2016, and as of that date would be repealed, unless a later enacted statute, that is enacted before January 1, 2016, deletes or extends that date.

#### Relief Provision

This provision would be operative for increases 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 the exclusion provision by this bill.

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The relief provision would remain in effect only until January 1, 2018, and as of that date would be repealed, unless a later enacted statute, that is enacted before January 1, 2018, deletes or extends that date.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.<sup>1</sup> 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.<sup>2</sup> A percentage of the excluded gain is an alternative minimum tax preference;<sup>3</sup> 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.

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<sup>1</sup> IRC §1202.

<sup>2</sup> IRC §1(h).

<sup>3</sup> 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.

## 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,<sup>4</sup> and instead provides its own exclusion and deferral provisions.<sup>5</sup>

### California QSBS Treatment Prior to the *Cutler* Decision<sup>6</sup>

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);
- 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*,<sup>7</sup> 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.

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<sup>4</sup> R&TC §§18152 and 18038.4, respectively.

<sup>5</sup> R&TC §§18152.5 and 18038.5, respectively.

<sup>6</sup> *Cutler v. Franchise Tax Board* (2012) 208 Cal. App. 4th 1247.

<sup>7</sup> *Cutler v. Franchise Tax Board*, Super. Ct. L.A. County, 2012, No. BC421864.

### California QSBS Treatment after the *Cutler* Decision

As explained in FTB Notice 2012-03,<sup>8</sup> 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*,<sup>9</sup> 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.

#### 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 only 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 (12 percent of the \$20,000 gain).

The bill would also allow taxpayers that received or will receive installment sales payments to exclude 38 percent of the gain included in installment payments received in taxable years beginning on or after January 1, 2008, for sales or exchanges of QSBS made in taxable years beginning before January 1, 2013.

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.

<sup>8</sup> [FTB Notice 2012-03](#), dated December 21, 2012.

<sup>9</sup> *River Garden Retirement Home v. Franchise Tax Board* (2010) 186 Cal. App. 4th 922.

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).

### Relief Provision

This bill would accomplish the following:

- Prohibit the accrual of interest and imposition of any penalty on the additional tax due as defined in this bill.
- Require that the FTB enter into a written installment payment agreement with the taxpayer, for up to five years, for the payment of additional tax due as defined in this bill.
- 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.<sup>10</sup>

This bill would 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, for which the normal four year statute of limitations would have expired as of the effective date of the act.

### **LEGISLATIVE HISTORY**

AB 1412 (Bocanegra, 2013/2014) is nearly identical to SB 209, except the gain exclusion is 50 percent. AB 1412 is currently enrolled.

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 prohibit 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 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.

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<sup>10</sup> The bill would also provide that if any provision of the statute (other than the relief provision discussed above) were to be held unconstitutional, that the provisions of the statute are not severable and the entire statute becomes invalid and unenforceable. If such a court finding were to occur when any of the years 2008 through 2012 are still open to adjustment under the four year statute of limitations, taxpayers benefitted by this bill would be subject to assessment for the open years. If such a court finding were to occur after the four year statute of limitations has passed for all of the years 2008 through 2012, no taxpayer would be subject to assessment.

**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**

This bill would not significantly impact the department’s costs.

**ECONOMIC IMPACT**

Revenue Estimate

Estimated Revenue Impact of SB 209				
Assumed Enactment By October 13, 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
Loss due to allowing exclusion on installment payment received beginning in 2013	N/A	- \$0.7	- \$0.5	- \$0.4
<b>Total **</b>	<b>- \$39.2</b>	<b>- \$32.2</b>	<b>- \$16.1</b>	<b>- \$14.2</b>

\* 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 (FYs) are as follows: - \$8.1 million in FY 2016-17, - \$2.5 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

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.

## APPOINTMENTS

None.

## SUPPORT/OPPOSITION<sup>11</sup>

Support: Bay Area Council; California Business Defense; California Healthcare Institute; TechAmerica; Silicon Valley Leadership Group; California Chamber of Commerce; Santa Monica Chamber of Commerce; West Hollywood Chamber of Commerce; BIOC.COM.

Opposition: California School Employees Association.

## VOTES

Concurrence	09/12/13	Y: 36	N: 2
Senate Floor	05/30/13	Y: 34	N: 3
Assembly Floor	09/12/13	Y: 73	N: 0

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<sup>11</sup> From Senate Governance and Finance Committee Analysis dated April 25, 2013, and Assembly Revenue and Taxation Committee Analysis dated August 9, 2013.

**LEGISLATIVE STAFF CONTACT**

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