



STATE OF CALIFORNIA
FRANCHISE TAX BOARD
Legal Branch
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KATHLEEN CONNELL
Chair

CLAUDE PARRISH
Member

B. TIMOTHY GAGE
Member

April 25, 2001

Information Letter No. 200856

RE: *****

Dear *****:

Your letter of *****, has been assigned to me for response. My review of your letter indicates that you are requesting a Chief Counsel Ruling. While it is the policy of the Franchise Tax Board to respond to inquiries from taxpayers, the Franchise Tax Board may decline to issue a ruling for a number of reasons. For your convenience, attached you will find a copy of Franchise Tax Board Notice 89-272 which identifies and discusses the guidelines for ruling requests. I would call your attention to section D, Instructions to Taxpayers Requesting Advance Rulings, most particularly subsection 1.

While we will not be issuing a Chief Counsel Ruling, I am pleased to provide you with this informational letter. You should be aware, however, that this letter is only advisory and the relief provisions of RTC section 21012 do not apply. You should also be aware that this discussion is subject to change, in the event of a change in relevant statutory authority, judicial or administrative case law, or a change in federal interpretation of federal law, where the discussion is based upon such interpretation.

As discussed in my telephone conversation with *****, your authorized representative, *****, RTC section 18152.5 allows a 50 percent exclusion of any gain from a sale of a qualified small business stock ("QSBS"), as long as the taxpayer holds the QSBS for five years and the qualified small business meets the statutory requirements during substantially all of the five years.

If, for example, QSBS was exchanged for non-qualified small business stock in year four as a result of the qualified small business being acquired by a non-qualified small business, but the non-qualified small business stock was kept for another year before disposing of it, the issue becomes whether RTC section 18152.5 applies to any gain on the sale.

RTC section 18152.5(f) provides some guidance. It states, in pertinent part:

- (f) If any stock in a corporation is acquired solely through the conversion of another stock in the corporation that is a qualified small

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business stock in the hands of the taxpayer, both of the following shall apply:

- (1) The stock so acquired shall be treated as qualified small business stock in the hands of the taxpayer.
- (2) The stock so acquired shall be treated as having been held during the period during which the converted stock was held.

Therefore, the statute provides that a non-qualified small business stock will be treated as qualified small business stock and the holding period will be carried over in the event there is an acquisition. Unfortunately, the statute provides little guidance in computing the amount of gain to exclude. Therefore, we look to legislative history. In the Legislative Change 93-22 for Senate Bill 671 (copy enclosed), it states, in pertinent part:

In the case of certain incorporations and reorganizations in which qualified small business stock is transferred for other stock, the transferor treats the stock received as qualified small business stock. The holding period of the original stock is added to that of the stock received. **However, the amount of gain eligible for the exclusion is limited to the gain accrued as of the date of the incorporation or reorganization.** This limitation does not apply in the case where the stock received in the incorporation or reorganization is itself qualified small business stock.

In the example, if the stock received in year four, as a result of the acquisition/reorganization, was a non-qualified small business stock, then the 50 percent exclusion of the gain is limited to that period in time. Thus, 50 percent of the gain that accrued from years one through four may be excluded. If you have any questions regarding this informational letter, please call me at the number above.

Very truly yours,

John Choi
Program Specialist – Legal Branch

Enclosures: FTB Notice 89-277
Legislative Change 93-22