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12.21.12

FTB NOTICE 2012-03

Subject: Implementation of Court of Appeal's Decision in *Cutler v. Franchise Tax Board* (2012) 208 Cal. App. 4th 1247.

Purpose

The purpose of this notice is to outline the procedures that the Franchise Tax Board will use in applying the Court of Appeal's holding in *Cutler v. Franchise Tax Board* (2012) 208 Cal. App. 4th 1247, that the qualified small business stock exclusion and deferral statutes – California Revenue and Taxation Code (CR&TC) sections 18038.5 and 18152.5 – are unconstitutional. In determining these procedures, the Franchise Tax Board was guided by the determination of the courts in *River Garden Retirement Home v. Franchise Tax Board* (2010) 186 Cal. App. 4th 922, and *McKesson Corp. v. Florida Alcohol & Tobacco Div.* (1990) 496 U.S. 18.

Background

In *Cutler v. Franchise Tax Board* (Super. Ct. L. A. County, 2012, No. BC421864), the taxpayer raised the issue of the constitutionality of California's qualified small business stock provisions (CR&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 qualified small business stock 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. Although the cause of action was remanded to the trial court for further proceedings, the issues that will be considered by the trial court on remand are not related to the implementation of the appellate court decision which is being addressed in this notice.

Implementation of *Cutler v. Franchise Tax Board*

The Franchise Tax Board has determined that because the Court of Appeal held that CR&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*, an appropriate remedy is to deny the exclusion/deferral to taxpayers who benefited from either the exclusion/deferral.

However, because the determination of the appropriate remedy for an unconstitutional provision also requires treating similarly situated taxpayers the same, this remedy cannot be applied to taxpayers for taxable years beyond the four-year statute of limitations. Since other similarly situated taxpayers have already benefitted from the exclusion/deferral, and the time within which to issue Notices of Proposed Assessment denying them the deferral/exclusion has expired, it is not possible for similarly situated taxpayers to be treated similarly for years outside the normal four year statute of limitations. Therefore, for taxable years beginning before January 1, 2008, the only way to place similarly situated taxpayers in the same position is to allow the exclusion/deferral to taxpayers who meet the requirements of the statutes other than the unconstitutional California property and payroll requirements.

For taxable years beginning on or after January 1, 2008, the department will disallow all CR&TC section 18152.5 exclusions and CR&TC section 18038.5 deferrals.

The *Cutler* decision and this notice have no effect on settlements and closing agreements that determined the tax treatment of gain from the sale or exchange of qualified small business stock.

Specific Procedures:

1. Taxable Years Beginning Before January 1, 2008

a. Returns Were Accepted as Filed

No further taxpayer action is required.

b. Tax Years in Which There is an Audit, Protest or Claim Currently Pending Before the Franchise Tax Board or an Appeal Currently Pending Before the State Board of Equalization in Which the Qualified Small Business Stock Exclusion and/or Deferral is at Issue

No further taxpayer action is required. Franchise Tax Board staff will apply the Department's position as set forth in this notice and as appropriate for each individual case.

c. Tax Years for Which A Statute of Limitations Is Open and There is No Claim for Refund Pending Before the Franchise Tax Board for Refund Requesting an Overpayment of Tax Attributable to the Qualified Small Business Stock Issue(s)

If a statute of limitations is open and the taxpayer or authorized representative wishes to file a claim (or protective claim) for refund of tax attributable to an exclusion or deferral of QSBS gain, the taxpayer or representative should mail an amended return to the following address:

US Mail:

Cutler Claim for Refund 347 MS: F381
Franchise Tax Board
C/O FTB Notice 2012-03
P.O. Box 1779
Rancho Cordova, CA 95741-1779

For Courier Service Delivery or Private Courier Mail:

Franchise Tax Board
9646 Butterfield Way
Sacramento, CA 95827

The amended return should indicate at the top of the return in red "QSBS CLAIM FOR REFUND" and should include a computation of the claimed refund amount.

2. Taxable Years Beginning On or After January 1, 2008

As set forth above, the Court of Appeal determined that the qualified small business stock statutes were invalid and unenforceable. The Franchise Tax Board will individually notify taxpayers who reported a qualified small business stock exclusion or deferral for taxable years beginning on or after January 1, 2008 that because these provisions are invalid and unenforceable, Notices of Proposed Assessments will be issued denying the exclusion or deferral.

Alternatively, taxpayers who received the benefit of either the deferral or exclusion and wish to self-assess and pay additional tax before they are contacted by FTB should file an amended return reporting an increase in tax liability due to the disallowance of the deferral or exclusion. The amended return and accompanying payment may be sent to:

US Mail:

Cutler Payment of Tax Due 347 MS: F381
Franchise Tax Board
C/O FTB Notice 2012-03
P.O. Box 1779
Rancho Cordova, CA 95741-1779

For Courier Service Delivery or Private Courier Mail:

Franchise Tax Board
9646 Butterfield Way
Sacramento, CA 95827

The amended return should indicate at the top of the return in red "QSBS PAYMENT OF TAX DUE".

Additional Information

For additional information, please see [Frequently Asked Questions \(FAQs\)](#).

The principal author of this notice is Ann Hodges of the Franchise Tax Board, Legal Division. For further information regarding this notice, contact Ms. Hodges at P.O. Box 1720, Rancho Cordova, CA 95741-1720.