California Small Business Stock Exclusion Declared Invalid

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Federal Small Business Stock Exclusion

Internal Revenue Code (IRC) §§1202 and 1045 provide for the exclusion or deferral of gain from the sale or exchange of qualified small business stock (QSBS). IRC §1202 provides that taxpayers (other than corporations) can exclude 50 percent of any gain from the sale or exchange of QSBS issued after August 10, 1993, and held for more than five years. When the 50 percent exclusion applies, the remaining 50 percent of the gain is taxed at a 28 percent capital gain rate (IRC §1(h)(5) and (8)). Thus, the entire gain is taxed at an effective rate of 14 percent (50 percent of gain taxed × 28 percent rate). Since 7 percent of the excluded gain is an alternative minimum tax (AMT) preference item, the QSBS exclusion is less attractive while the regular 15 percent capital gains rate is currently about the same as the QSBS rate.

QSB stock is domestic C corporation stock, acquired by the taxpayer at its original issue in exchange for money or property. The domestic C corporation's aggregate gross assets cannot exceed $50 million and at least 80 percent of assets are used in the active conduct of one or more qualified businesses, which is any business except businesses in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any business where the principal asset of the business is the reputation or skill of one or more of its employees. Additional disqualified businesses include ones involved in banking, insurance, financing, leasing, investing, farming (including the raising or harvesting of trees), businesses extracting or producing natural resources eligible for percentage depletion, hotels, motels and restaurants.

Temporary Increases in the Federal Exclusion

The 2010 Small Business Jobs Act enhanced the exclusion of gain from qualified small business stock to non-corporate taxpayers. For stock acquired after September 27, 2010 and before January 1, 2011, and held for at least five years, the 2010 Small Business Jobs Act provided an exclusion of 100 percent. The 2010 Tax Relief Act extended the 100 percent exclusion for one more year, for stock acquired before January 1, 2012. On January 1, 2013, the American Taxpayer Relief Act of 2012 extended the 100 percent exclusion through the end of 2013. In addition, none of the excluded gain is treated as a tax preference item for AMT purposes, so stock gains qualifying for the 100 percent exclusion will be received completely tax free! Since the investor must hold the stock for five years, stock purchased in 2011 must be held until 2016 before it is eligible for the enhanced exclusion.

For qualified small business stock acquired after February 17, 2009 and before January 1, 2011, the American Recovery and Reinvestment Act of 2009 increased the 50 percent gain exclusion to 75 percent. As a result of the increased exclusion, gain from the sale of qualified small business stock acquired during the applicable time period is taxed at a maximum effective rate of 7 percent under the regular tax (25 percent of the gain taxable at 28 percent yields the equivalent of 100 percent of the gain taxable at 7 percent).

California Exclusion

Beginning in 1993, California adopted its own stand-alone QSBS provisions (R&TC §18152.5) dealing with exclusions, which generally mirrored existing federal law. The California exclusion is 50 percent of the gain on the sale of qualifying small business stock originally issued after August 10, 1993 that was held for more than five years. California has required corporations to file *Form FTB 3565 Small Business Stock Questionnaire*, if the corporation qualified as a "qualified small business" and issued stock during the current taxable year. In 1998, California adopted its own stand-alone QSBS provision dealing with deferrals.

California also did not conform to the federal increase in exclusion to 75 percent for stock acquired after February 17, 2009 or to the 100 percent exclusion for stock acquired after September 27, 2010 and before January 1, 2011.

California's Two 80 Percent Rules

However, California's R&TC §§18152.5 and 18038.5 required that at least 80 percent of the company's payroll at the time the stock was purchased must be within California and 80 percent of assets and payroll must be within California during the taxpayer's holding period for the stock in order to qualify for a QSBS gain exclusion or deferral.

Unconstitutionality Upheld in Court of Appeals

In August 2012, these provisions in California law regarding the 80 percent asset and payroll requirements were found to be unconstitutional by the California Second District Court of Appeal in *Cutler v. Franchise Tax Board* (FTB). The

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Court of Appeal 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.

The FTB determined that because the Court of Appeal held that R&TC §§18152.5 and 18038.5 are unconstitutional, these sections are now invalid and unenforceable and the appropriate remedy is to deny the exclusions and deferrals to taxpayers who benefited from either. It is **important** to note that the court's decision in *Cutler* did not change the federal treatment of QSBS.

FTB Notice 2012-03

On December 21, 2012, FTB released their legal decision based on the outcome of the *Cutler* decision. In FTB Notice 2012-03, FTB states that **ALL** taxpayers will be denied the small business stock exclusion for all years still open under the statute of limitations beginning with 2008.

Taxpayers who used the small business stock exclusion can either:

1. Wait for a correspondence from FTB, increasing their tax balance from the denied code sections; or
2. Voluntarily amend their returns.

Although R&TC §19142(b)(1) allows an exception to the estimated tax penalty when a change is due to a provision of the law that is chaptered during the year, it does not apply to changes due to the application of court decisions. Interest will apply on amounts due.

Important Caution for 2008 Returns

Under R&TC §19116, interest may be suspended where a proposed deficiency notice is not issued within 36 months of the original due date of the return or the date the original or amended return was filed, whichever is later. Since the due date of the 2008 return is more than 36 months ago, taxpayers should wait for FTB to make the adjustment by issuing a Notice of Proposed Assessment (NPA) rather than voluntarily filing an amended return. If a taxpayer voluntarily files an amended return to include the previously excluded QSBS gain when more than 36 months have elapsed since they filed their 2008 return, no interest suspension would be allowed by law.

FTB will automatically compute any applicable interest suspension amount on a proposed deficiency assessment. To qualify for interest suspension for 2008, taxpayers should compute the additional tax and pay this amount as a tax deposit without filing an amended return. The amount paid will be applied against the tax liability shown on the FTB's NPA. Interest suspension will then apply to the periods after the expiration of 36 months from the date the original return was filed and the date that the FTB issues its NPA.

Conclusion

There could be further developments on FTB's aggressive position that California's QSBS exclusion is invalid retroactively to all open years 2008 through 2011. In particular, there could be practitioner as well as industry "push-back" in reaction to Notice 2012-03, since it is only 30 days old at the time this article was written. The FTB declaration that the statutes are invalid retroactively vs. from the effective date of the court's ruling could still be challenged.

FTB has posted FAQs on their website at: https://www.ftb.ca.gov/law/Qualified_Small_Business_Stock_and_Cutler_Decision.shtml.

Vicki L. Mulak, EA, CFP® is a well-known tax law update and business entity presenter for NAEA, CSEA, CSTC and Best of the West. She is an editor of PPC's *Accounting and Bookkeeping Quickfinder Handbook*. She is the recipient of the 2012 NAEA Bill Payne Advocacy Award. In 2011, she received CSEA's Distinguished Service Award and in 2006, the Thomas P. Hess Award. In 1996 she was named Small Business Administration's Accountant Advocate of the Year. She serves on California's FTB and EDD advisory committees and testifies on California legislation. Since 1986, her Tustin, CA practice, American Financial and Tax, has specialized in both individual and small business tax preparation and planning.

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