Tax Alert: FTB Disallows California Qualified Small Business Stock Benefits

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Summary: The California Franchise Tax Board (FTB) recently issued FTB Notice 2012-03, stating that the FTB will disallow the exclusion or deferral of gain under California's qualified small business stock (QSBS) statute for all tax years beginning on or after January 1, 2008. FTB Notice 2012-03 comes on the heels of the California Court of Appeal's decision in *Cutler v. Franchise Tax Board*, 208 Cal. App. 4th 1247 (2012), where the court held that California's QSBS rules impermissibly favor California corporations in violation of the commerce clause of the U.S. Constitution. Rather than simply striking the particular offending provisions from the California QSBS statute, the FTB has deemed the entire California QSBS statute to be invalid and unenforceable, thereby impacting all California taxpayers who have claimed QSBS exclusion or deferral benefits in recent years. The *Cutler* decision and FTB Notice 2012-03 impact only the California QSBS rules, and do not affect the availability of federal QSBS benefits under the Internal Revenue Code.

Background: In *Cutler v. Franchise Tax Board*, the taxpayer sought to defer gain from the sale of stock under California's QSBS deferral provisions (*Rev & Tax. Code* §§ 18038.5, 18152.5). The FTB disallowed the deferral, due in part to the fact that the stock that was sold did not meet California's property and payroll requirements. Under the California QSBS statute, the exclusion or deferral of gain is limited generally to stock of a company where (1) at least 80% of the assets of the company are used in a qualified trade or business in California, and (2) at least 80% of the company's payroll expense is attributable to employment in California. The trial court held in favor of the FTB and concluded that the California property and payroll requirements were permissible.

The taxpayer appealed the trial court decision, and the Second District Court of Appeal ruled in favor of the taxpayer, finding that the California property and payroll requirements violate the "dormant commerce clause" under Article I of the U.S. Constitution. The court determined that the California property and payroll requirements caused the QSBS statute to impermissibly discriminate against interstate commerce by favoring investment in corporations doing business within California, and discouraging California corporations from engaging in interstate commerce.

Although the Court of Appeal held for the taxpayer on the unconstitutionality of the California property and payroll requirements, the court remanded the case to the trial court to determine whether the taxpayer met certain other requirements (unrelated to the California property and payroll requirements) under the California QSBS statute.

FTB Notice 2012-03: FTB Notice 2012-03 announces the FTB's implementation of the *Cutler* decision, and states that because the California Court of Appeals held that the California QSBS provisions are unconstitutional, these sections are now invalid and unenforceable. The Notice states that the appropriate remedy is to deny the exclusion or deferral of QSBS gain under the California QSBS statute generally to all taxpayers. However, because the determination of the appropriate remedy also requires treating similarly situated taxpayers the same, the Notice states that this denial remedy cannot be applied to taxpayers for taxable years beyond the four-year statute of limitations in California. Accordingly, for taxable years beginning before January 1, 2008, the FTB will allow the exclusion/deferral to taxpayers who meet the requirements of the California QSBS statute other than the California property and payroll requirements if the statute of limitations is still open. Taxpayers whose statute of limitations are now closed for these earlier taxable years are not affected by the Notice. For taxable years beginning on or after January 1, 2008, the FTB will disallow all QSBS exclusions and deferrals under the California QSBS statute.

In setting forth its position in the Notice, the FTB characterizes the decision in *Cutler* as holding that the entire QSBS statute (*Rev. & Tax. Code* §§ 18152.5 and 18038.5) is unconstitutional. The Court of Appeal in *Cutler* determined specifically that the California property and payroll requirements under the California QSBS statute are unconstitutional. Although the Court of Appeal did not determine whether the taxpayer ultimately was entitled to a refund, the Court of Appeal remanded the case to the trial court to determine whether the taxpayer met the other requirements under the QSBS statute. If the Court of Appeal was of the view that the entire statute is unconstitutional and that any possibility for the deferral of gain was eliminated by its holding, it would seem unnecessary for the Court to remand the case to the trial court for further consideration of whether the taxpayer met the remaining QSBS requirements.

The Court of Appeal's decision in *Cutler* and FTB Notice 2012-03 impact only the California QSBS rules, and do not affect the availability of federal QSBS benefits under the Internal Revenue Code.

Next Steps: Taxpayers who reported (or who may be eligible for) California QSBS benefits in the past are urged to consult with their tax advisers to determine the appropriate course of action in light of the *Cutler* case and FTB Notice 2012-03. In particular, taxpayers whose statute of limitations remain open for pre-2008 taxable years and who have not claimed California QSBS deferral or exclusion benefits due to the California property and payroll requirements should consider filing an amended return to claim such benefits for pre-2008 years. For those taxpayers who claimed California QSBS benefits for taxable years beginning on or after January 1, 2008, the FTB has stated that it will issue Notices of Proposed Assessments denying the exclusion or deferral. The FTB has stated that interest will accrue on a balance due as prescribed by California law. In this regard, FTB Notice 2012-03 states that taxpayers may wish to self-assess and pay additional tax before they are contacted by the FTB by filing an amended return.

Note, however, that California's interest suspension rules (which suspend the accrual of interest if an assertion of tax is not made within 36 months after a tax return is timely filed) may make it advantageous for certain taxpayers to wait for the FTB to make an adjustment by Notice of Proposed Assessment rather than by filing an amended return, particularly where more than 36 months have already elapsed since a taxpayer's return was timely filed.

In light of the above considerations, taxpayers who are potentially affected by the *Cutler* decision and the FTB's position in Notice 2012-03 should contact their tax advisers to determine whether further action is advisable or required in relation to their California income tax returns.

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