PERSPECTIVE
Los Angeles | Daily Journal
TUESDAY, OCTOBER 15, 2013

California Qualified Small Business Stock Tax Break Fixed — Retroactively

By Robert W. Wood

A tax *cut* in California? A tax cut that is *retroactive*? A tax cut favoring businesses and investors? No, it is not April Fools' Day, and this is not a joke. This is a rare piece of *good* California tax news.

It comes on the heels of many years of not so attractive developments. It was just last year that California enacted sweeping retroactive tax hikes. They sent tax rates for $1 million earners to a stratospheric 13.3 percent, up from a previous top rate of 10.3 percent. The migration out of California has been palpable, causing Texas Gov. Rick Perry to sojourn here to tease businesses away.

But in a rare about face, on Oct. 4 Gov. Jerry Brown signed into law Assembly Bill 1412, a bill that reinstates a controversial California tax break. The law retroactively allows Qualified Small Business Stock exclusions and deferrals for 2008-2012.

First, the back story. Federal income tax law allows a major tax break for gain from the sale of qualified small business stock (QSBS). Broadly stated, QSBS is issued by a C corporation that has no more than $50 million of assets and that uses at least 80 percent of its assets in an active business. Certain businesses are not eligible for the break, including those involved in personal services, finance, farming, restaurants and hotels.

California's version of this QSBS tax break allowed the exclusion of 50 percent of capital gain earned from investments under $50 million. California's version generally mirrored federal law but with a key California focus that required virtually everything to be within the state. Thus, to qualify for a California tax break, California law required that at least 80 percent of the company's payroll was located in California at the time the stock was purchased.

Plus, California law said that 80 percent of the company's assets and 80 percent of its payroll also had to be within California during the time the taxpayer held the stock. Even worse, California was so rigid about its interpretations that battles were frequent. Eventually, in August 2012, California's law regarding the 80 percent asset and payroll requirements was ruled unconstitutional by the 2nd District Court of Appeal in *Cutler v. Franchise Tax Board*, 2013 DJDAR 12033 (Aug. 28, 2012).

Instead of just applying the QSBS law *without* the 80 percent California spin, California's aggressive tax administration struck back with a vengeance. In the Franchise Tax Board's opinion, instead of just the 80 percent test, the court's decision made California's *entire* QSBS statute invalid and unenforceable. That meant everyone who had claimed the benefit was sent a retroactive tax notice.

The FTB said *all* QSBS gain exclusions and deferrals previously allowed under California law became invalid. Many thought that was a bizarre reading of the case, but the FTB pushed hard. According to the FTB, taxpayers who previously took advantage of California's preferential treatment of QSBS in years still open for assessment under the four-year statute of limitations (generally 2008 and later) had to recompute their taxable income for each affected year without excluding or deferring gains from the disposition of QSBS.

Many were suddenly facing crippling tax liabilities. Fortunately, AB 1412 breaks with California's fiercely fought tax rules and reinstates the QSBS rules without the offending California focus. Now there is no requirement for the company to have 80 percent of its assets and payroll in California while the taxpayer held the stock. What's more, California taxpayers who have not yet filed their 2012 return can claim the QSBS exclusion or deferral.

For taxpayers who filed their 2008-2012 tax returns and who were contacted by the FTB regarding their QSBS election, the FTB will notify them that pending Notices of Proposed Assessment based on the *Cutler* decision or FTB Notice 2012-3 will be withdrawn. Some investors are likely to frame those notices of withdrawal!

Taxpayers who have received bills for unpaid taxes, interest or penalties assessed as a result of the *Cutler* decision/FTB Notice 2012-3 will be abated. Those notices will be welcome too. And the FTB even has to give refunds for payments received related to the *Cutler* decision/FTB Notice 2012-3.

Unusually, it's not even necessary for the taxpayers to file claims for refund. The FTB has announced that no action is needed by taxpayers to request refunds, unless they do not hear from the FTB by Nov. 30. In these circumstances, taxpayers may contact the FTB at 916-845-3030.

If a federal QSBS exclusion was claimed but the California QSBS exclusion was not, a taxpayer may want to file an amended California return to claim the exclusion. The California exclusion could be applicable if the company had 80 percent of its payroll in California when the taxpayer purchased the stock. All refund claims must be filed prior to the expiration of the statute of limitations.

In addition to the normal four-year statute of limitation, AB 1412 allows taxpayers until June 30, 2014, to file a QSBS claim for refund for tax year 2008. Amended returns should state in red "QSBS CLAIM FOR REFUND" at the top of the return, and be mailed to: 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, Sacramento, CA 95827. For additional information, check the FTB's website for guidance, which should be posted in the near future.

Is this legislation a big deal? It sure is. It was the only thing that seemed remotely fair. Still, as tough a tax environment as prevails in California, it wasn't a forgone conclusion. It is too soon to say whether this signifies a change in California's tax policy. It probably doesn't. Still, it is a remarkable enough development that all of us who thought California taxes were a one way street should take note.

Robert W. Wood *is a tax lawyer with a nationwide practice (www.WoodLLP.com). The author of more than 30 books including "Taxation of Damage Awards & Settlement Payments" (4th Ed. 2009 With 2012 Supplement www.taxinstitute.com), he can be reached at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.*