

California – Bills propose extending qualified small business stock gain exclusion/deferral to investments in out-of-state businesses in response to ‘Cutler’

September 27, 2013

In brief

The California Legislature approved two bills, [S.B. 209](#) and [A.B. 1412](#), in response to the recent *Cutler* decision, which found unconstitutional the state’s requirement that qualified small business stock (QSBS) exclusions/deferrals are limited to investments in businesses predominately based in California. The Franchise Tax Board’s response to *Cutler* was to deny the QSBS exclusion/deferral to all investments. In contrast, the proposed bills would remove the in-state requirement, thus applying the QSBS exclusion/deferral to investments in both in-state and out-of-state businesses.

If either bill is enacted, California taxpayers should consider filing refund claims for gains realized from prior years that may have otherwise qualified for gain exclusion/deferral but for the in-state business requirement.

In detail

Cutler – Gain deferral limited to in-state businesses facially unconstitutional

California allows individual taxpayers a 50% *exclusion* and/or a *deferral* on gains relating to qualified small business stock. California statutes limit this exclusion/deferral to investments in small businesses predominately based in California.

On August 28, 2012, a California Court of Appeals ruled in *Cutler v. Franchise Tax Board* that the state’s limitation of QSBS gain deferral to *in-state businesses* was unconstitutional. The ruling presumably applies to the 50% QSBS gain exclusion as well. [Click here](#) for our summary of the *Cutler* decision.

FTB response – Deny previously allowed QSBS gain exclusions and deferrals starting in 2008

The FTB responded to the *Cutler* decision by announcing,

in Notice 2012-03, that it would deny taxpayers the QSBS exclusion/deferral for 2008 and later years because the exclusion/deferral was “unconstitutional, invalid, and unenforceable.” [Click here](#) for our summary of Notice 2012-03, issued in December 2012.

On February 28, 2013, the FTB provided on an [FAQ web page](#) that it was going to send Notices of Proposed Assessments to taxpayers in early April 2013 to ensure collection of denied

QSBS exclusions and deferrals. The FTB also instructed taxpayers who claimed the QSBS deferral or exclusion to file amended returns back to 2008 and pay any tax as a result. [Click here](#) for our summary of the FAQ guidance.

Legislative proposal – Remove in-state requirement, repeal exemption in 2016

S.B. 209 and A.B. 1412 remove the unconstitutional defect limiting QSBS gain exclusion/deferral to only in-state businesses. Specifically, both bills would:

- remove the in-state requirement for QSBS gain exclusions/deferrals for taxable years beginning on or after January 1, 2008, and before January 1, 2013
- repeal the QSBS gain exclusion/deferral by providing that the exclusion/deferral exemptions are “in effect only until January 1, 2016”
- waive the imposition of penalties and interest accrual directly related to additional tax assessed as a result of the *Cutler* decision
- allow taxpayers to file a claim or credit for refund for taxable years beginning on or after January 1, 2008, and ending before January 1,

2009, within 180 days from the bill’s effective date.

The one difference between the bills is the amount of relief to be provided from the QSBS exclusion of gains. A.B. 1412 excludes 50% of any gain from the sale of QSBS while S.B. 209 excludes 38% of any gain from the sale of QSBS.

Bill status

S.B. 209 passed the Senate (36-2) and the Assembly (73-0) and was presented to the governor on September 20, 2013.

A.B. 1412 passed the Senate on September 11, 2013, (36-1) and the Assembly on September 12, 2013, (77-0) and is expected to be presented to the governor soon.

Once in his possession, the governor generally has 30 days to sign or veto a bill, otherwise the bill becomes law on the 31st day.

The takeaway

If either bill is enacted, California taxpayers would receive a significant retroactive remedy extending exclusions and deferrals of QSBS gains to investments in out-of-state businesses. If enacted, California taxpayers should consider filing refund claims for gains realized from prior years that may have otherwise

qualified for gain exclusion/deferral but for the in-state business requirement.

While the statute of limitations will soon close for the 2008 tax year, both S.B. 209 and A.B. 1412 would provide taxpayers with 180 days following either bill’s effective date to file a refund claim for the 2008 tax year.

Taxpayers should be aware of the additional tax that may be imposed should S.B. 209 be enacted. As a legislative compromise to extending the gain exclusion/deferral to out-of-state investments, S.B. 209 decreases the exclusion percentage from 50% to 38%, retroactive to the 2008 tax year. Taxpayers who followed the law at the time and took a 50% exclusion relating to in-state investments will be subject to an assessment for the incremental decrease in the exclusion percentage. This may be a more favorable result than the Department’s position to disallow the exclusion entirely, but the bill’s retroactive imposition of tax may be subject to challenge.

It is unknown whether the governor will sign or veto either bill. We will monitor the progress of the bills and report on any significant developments.

Let’s talk

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