
California – Qualified small business stock gain exclusion/deferral extended in response to *Cutler*, FTB provides refund guidance

October 9, 2013

In brief

California Governor Jerry Brown signed [A.B. 1412](#) on October 4, 2013, 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, A.B. 1412 removes the active in-state requirements, thus applying the QSBS exclusion/deferral to investments in: (1) in-state businesses that remain predominately in-state and (2) in-state businesses that may have expanded to include out-of-state business operations.

California taxpayers should consider filing refund claims for gains realized from prior years that may have otherwise qualified for gain exclusion/deferral but for any in-state business requirement. Taxpayers have until June 30, 2014, to file refund claims for the 2008 tax year. However, certain provisions of A.B. 1412 could subject such claims to additional scrutiny.

On October 7, 2013, the FTB provided refund guidance in the form of an FAQ page on its website.

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 limited 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.

New law removes active in-state requirement, repeals exemption in 2016

A.B. 1412 removes the unconstitutional defect limiting QSBS gain exclusion/deferral to only predominately in-state businesses. Specifically, A.B. 1412:

- removes the active in-state requirement for QSBS gain exclusions for sales, including installment sales, occurring in taxable years beginning on or after January 1, 2008, and before January 1, 2013, and installment payments received in taxable years beginning on or after January 1, 2008, for sales of QSBS made in taxable years beginning before January 1, 2013
- removes the active in-state requirements for QSBS gain deferrals for sales made after August 5, 1997, and before January 1, 2013

- repeals the QSBS gain exclusion/deferral by providing that the exclusion/deferral exemptions are “in effect only until January 1, 2016”
- waives the imposition of penalties and interest accrual directly related to additional tax assessed as a result of the changes to the definition of QSBS
- allows 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.

FTB’ provides refund guidance

On October 7, 2013, the FTB posted an [FAQ page on its website](#) recognizing that A.B. 1412 retroactively allows the QSBS deferral and 50% gain exclusion for tax years 2008 to 2012. The FAQs:

- instruct taxpayers who have not filed their 2012 tax return how to claim the exclusion or deferral
- notify taxpayers that it will withdraw proposed assessments based on the *Cutler* decision and provide other relief
- instruct taxpayers who filed their 2008-2012 tax returns and did not claim the QSBS election how to claim the exclusion or deferral.

The FAQs recognize that the California 80 percent payroll requirement at the time of acquisition must be satisfied in order to qualify for the exclusion or deferral.

The takeaway

The governor approved a companion bill as well, S.B. 209. Because A.B. 1412 was signed following S.B. 209, the [provisions of A.B. 1412 prevail](#).

California taxpayers may receive a significant retroactive remedy due to the extension of exclusions and deferrals of QSBS gains to investments in in-state companies that may have expanded to include out-of-state business operations. 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 active in-state business requirement.

Taxpayers should consult with a multistate specialist before proceeding with a refund claim for investments in entirely out-of-state businesses. As recognized by the [FTB’s bill analysis](#), certain surviving statutory provisions similar to those invalidated in *Cutler* may be subject to challenge. Notably, A.B. 1412 retains the QSBS requirement that at least 80 percent of the corporation’s payroll is attributable to employment located within California at the time of stock issuance. The FTB, through its FAQs, suggests that it will enforce this 80 percent payroll requirement.

While the statute of limitations will soon close for the 2008 tax year, A.B. 1412 provides taxpayers until June 30, 2014, to file refund claims for the 2008 tax year.

Let's talk

If you have questions on either bill, or any of the historical proceedings, please contact any of the following individuals:

State and Local Tax Services

Sam Melehani
Partner, *Los Angeles*
+1 (213) 356-6900
sam.melehani@us.pwc.com

Eran Liron
Partner, *San Jose*
+1 (408) 817-3937
eran.j.liron@us.pwc.com

Brian Rebhun
Principal, *New York*
+1 (646) 471-4024
brian.rebhun@us.pwc.com

Alan Bollinger
Director, *Sacramento*
+1 (916) 930-8203
alan.d.bollinger@us.pwc.com