



## QUALIFIED SMALL BUSINESS STOCK – AN EXPLANATION AND UPDATE

By Christopher A. Karachale

Imagine if Congress decided to lower to 0% the tax rate on gain of the sale of stock. It may surprise you to learn that since 2010 such a provision has existed in the Internal Revenue Code (IRC). Gains of up to \$10 million from the sale of qualified small business stock (QSBS) were entirely exempt from federal income tax provided the seller held the stock for five years and sold before December 31, 2013. Given the current 20% capital gains rate for high earners, as well as the additional 3.8% net investment income tax that went into effect on January 1, 2013, QSBS provided significant tax savings for many taxpayers.

However, the special dispensation for QSBS is scheduled to sunset at the end of 2013. Unless Congress acts, IRC Section 1202, which prescribes the rules for QSBS qualification, will revert to its pre-2010 level and allow taxpayers to exclude only 50% of the gain from the sale of their QSBS. Of course, a 50% exclusion is still pretty generous. However, with recent changes to the California tax treatment of QSBS, the net result means that QSBS may not be the boon it once was for taxpayers.

### What is QSBS

QSBS is stock that has been issued directly to a shareholder after August 10, 1993 from a “qualified small business.” A qualified small business is a C corporation (not a pass-through entity such as a partnership or S corporation) that has gross assets of less than \$50 million immediately before it issues its stock. IRC Section 1202(d). Most importantly, at least 80% of the assets of a qualified small business must be dedicated to an active trade or business other than providing services, such as law, engineering, architecture, accounting, or financial services. IRC Section 1202(e).

Prototypically, a qualified small business is a computer company or other small or start up technology company that manufactures hardware. However, any manufacturing company can generally meet the requirements to be treated as a qualified small business.

Provided the requirements for a qualified small business are met, the holders of QSBS are entitled to exclude the gain from the sale of their shares. However, additional benefits are available to the QSBS shareholders. If, for example, the qualified small business merges with another larger company (that is not a qualified small business) and the shareholders receive stock in exchange for their QSBS, the shareholders may be able to “tact” their QSBS to the

shares of the larger company. When they dispose of those shares, the shareholders may obtain the benefit of the QSBS exclusion to which they would have been entitled had they not received new non-QSBS stock through a merger. IRC Section 1202(h)(4).

In addition, shareholders of QSBS may also defer (rather than exclude) gain from the sale of their QSBS provided they reinvest the proceeds of their QSBS in a new qualified small business. IRC Section 1045. Many QSBS shareholders continue to rollover their gain into new QSBS effectively avoiding taxation indefinitely.

### How Does California Handle QSBS

Until recently, the California Revenue & Taxation Code (R&TC) generally conformed to the IRC with respect to the treatment of QSBS. But in the last year and a half, significant judicial and legislative actions have dramatically  
*(Continued on page 10.)*

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*(President's Message, continued from page 1.)*

Kate Rockas, and retired Judge Michael Dufficy), and your incoming officers (Secretary Larry Strick, Treasurer Scott Rogers, President-elect Randy Wallace, President Elizabeth Brekhus and 5-year Past President Terry Mason).

Finally, the proceeds of the silent auction will benefit the MCBA legal scholarship. MCBA asks that you consider donating to the legal scholarship fund.

I am looking forward to a great year, and I hope to see you on the 11th!

*(Holiday Party, continued from page 1.)*

as they enjoy their well-deserved retirements, and we hope we will see them at the holiday party for years to come. Outgoing MCBA President Joel Gumbiner and incoming President Elizabeth Brekhus shared a moment of holiday greetings.

The food was scrumptious, the drinks were flowing, and MCBA thanks everyone in the crowd of more than one hundred people for sharing the holiday season with us.



*Elizabeth Brekhus and Joel Gumbiner*

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*(Qualified, continued from page 5.)*

changed the treatment of QSBS under the R&TC. R&TC Sections 18152.5 and 18038.5 previously provided that for California tax purposes, taxpayers could exclude or defer 50% of the gain from the sale of QSBS, provided that 80% of the qualified small business's assets were used in an active business in California and 80% of the qualified small business's payroll was attributable to employment located within California.

However, in August 2012, a California appellate court ruled that 80% in-state active business and payroll requirements were discriminatory and violated the commerce clause of the U.S. Constitution. *Cutler v. Franchise Tax Bd.*, 208 Cal. App. 4th 1247 (Cal. App. 2d Dist. 2012). In response, the Franchise Tax Board took the rather draconian position that R&TC Sections 18152.5 and 18038.5 were invalid statutes and unenforceable. Notice 2012-03. Based on this guidance, the Franchise Tax Board began to retroactively assess state taxes against taxpayers who had excluded or deferred gain from the sale of their QSBS for all tax years open under the statute of limitation. In short, California taxpayers who had excluded or deferred gain from the sale of their QSBS going back to 2008 began to receive notices indicating that tax was due as though no exclusion had ever been allowed.

This situation was clearly untenable and, in response, the California legislature passed, and Jerry Brown signed into law on October 4, 2013, AB 1412. This law amended the R&TC to allow California taxpayers to exclude or defer gain from sales of QSBS for 2008 through 2012 even if the qualified small business did not conduct 80% of its business in California. However, this correction came at a price; the current versions of Sections 18152.5 and 18038.5 provide for no exclusion or deferral of gain for QSBS sold in 2013 and subsequently.

#### **Conclusions**

Until recently, QSBS represented the El Dorado of stock ownership. It allowed taxpayers to exclude 100% of their gain at the federal level and 50% of their gain at the California state level. But recent and current legislative fixes have made QSBS less appealing. At the time of writing, the U.S. Congress appears unwilling to take up any tax-extendors for 2014. Similarly, the California legislature has eliminated the exclusion from gain for QSBS for 2013 and future years. Of course, both these bodies may act to resurrect tax benefits for QSBS. Taxpayers who invest in small businesses, especially in the Bay Area, should be aware of QSBS and the potential advantages it has held – and potentially once again will hold.

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