California QSBS Resolution Afoot?

by Christopher A. Karachale & Fred B. Weil

Since August 2012, California taxpayers have faced significant uncertainty regarding the treatment of their qualified small business stock (QSBS). At that time, a California appellate court ruled that elements of the 80% California-based property and payroll requirements of Revenue and Tax (R&T) Code Sections 18152.5 and 18038.5 were unconstitutional. On the face of it, it appeared that the court had broadened the QSBS tax benefit by eliminating one of the California-based conditions.

Then, in December 2012, the Franchise Tax Board, perhaps concerned about the revenue loss implications of the court's ruling, took the unusual and rather Draconian step of declaring that QSBS statutes were entirely unenforceable, since this was the only appropriate remedy for the elimination of the unconstitutional provisions. The effect would be to disallow QSBS gain exclusion and deferral prospectively, *and retroactively* through a disallowance for the QSBS benefits in all open tax years. This meant that California taxpayers potentially faced tax bills going back to 2008 even if they entirely complied with the California statutes at the time they disposed of their QSBS.

Fortunately, a legislative fix to the R&T Code has now been proposed. On April 3, 2013, Senator Ted Lieu (D-Torrance) introduced amendments to S.B. 209 which provide retroactive relief for QSBS holders and *some* prospective assistance for future QSBS sales. Under the bill, California taxpayers who disposed of QSBS between 2008 and 2012 would still be able to exclude or defer their gain, provided the qualified small business met the 80% California-based payroll requirement *at the time* the QSBS was acquired. Those taxpayer would not need to demonstrate that throughout substantially all time they held the QSBS, the 80% California-based criteria were met.

S.B. 209 also would suspend the QSBS rules for sales of QSBS stock between January 1, 2013 and December 31, 2015. Starting in 2016, the special exclusion and deferral rules will be reinstated. S.B. 209 represents a significant compromise for taxpayers since it repeals the QSBS benefits for the next three years. However, the bill does help all those taxpayer who currently face significant tax bills from the FTB arising from QSBS sales prior to 2013.

For taxpayers with questions about any issues related to the QSBS rules or other federal or state tax provisions, please contact the Hanson Bridgett Tax Practice Group.

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