Constitutional Crisis for Qualified Small Business Stock

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The Internal Revenue Code ("IRC") and California Revenue & Tax Code ("R&TC") contain many provisions intended to incentivize investment in small businesses. Nowhere is this more patent than in the sale of qualified small business stock ("QSBS"). Until January 1, 2012, IRC Section 1202 entirely excluded from federal income tax the greater of $10 million in gain from sale of QSBS or ten times the QSBS's adjusted basis, provided the seller had held the QSBS for at least five years. Currently, 50% of up to $10 million in gain or ten times the QSBS's adjusted basis is excludible for federal income tax purposes.

In California, similar special tax treatment has been afforded holders of QSBS. Under R&TC Section 18152.5, California taxpayers have been able to exclude from gross income 50% of the gain from the sale of QSBS held for more than five years. However, a recent California District Court of Appeal case, *Cutler v. Franchise Tax Bd*., 2012 Cal. App. LEXIS 924 (Cal. App. 2d Dist. Aug. 28, 2012), calls into question the constitutionality of R&TC Section 18152.5.

According to the California state appellate court, R&TC Section 18152.5 violates the commerce clause of the U.S. Constitution by discriminating against interstate activity. The ramifications of this ruling are not yet clear. However, *Cutler v. Franchise Tax Bd*. is bound to impact many corporations and their shareholders, especially in the high tech industry, where the favorable tax treatment of QSBS is integral to many investors' decision to acquire small businesses stock.

QSBS Requirements and Advantages

In general, IRC Section 1202 provides that a "qualified small business" means a domestic C corporation which does not have aggregate gross assets of more than $50,000,000. In addition, at least 80% of the C corporation's business must be an "active business," rather than investment activity or certain service provider businesses. Under R&TC Section 18152.5, California's standard for qualified small businesses mirrors IRC Section 1202.

However, the R&TC Section 18152.5 also requires that at least 80% (by value) of the assets of the qualified small business must be used in the active conduct of one or more qualified trades or businesses *in California*. Additionally, at least 80% of the corporation's total payroll expense must be attributable to employment located *within California*.

When a qualified small business is engaged in an active trade or business, its shareholders receive many benefits. As described above, upon disposition of the QSBS, shareholders typically can exclude at least 50% of the gain up to certain limits. But if the shareholders elect to rollover the gain from the sale of the QSBS to *another* qualified small business, additional deferral is also available. Under IRC Section 1045, no gain is recognized on the sale of QSBS if the shareholder reinvests in another QSBS within 60 days. California provides similar deferral at R&TC Section 18038.5.

Thus, at both the federal and California state level, an investor has many incentives to purchase QSBS. First, if the inventor holds the stock for five years, the investor can enjoy the exclusion of 50% of the gain upon disposition. Second, if the investor elects to roll over the sale proceeds from the QSBS into another qualified small business, the investor can essentially defer taxation on the gain from the QSBS forever.

<u>Appellate Court Decision</u>

In *Cutler v. Franchise Tax Bd*., the taxpayer sold stock he had acquired in an internet start-up and reinvested the proceeds in several other small businesses. On his California tax return, he deferred the gain from the sale of the stock that he had reinvested in the other small businesses. The FTB disallowed the gain deferral finding that the internet start-up stock was *not* QSBS since the company did not maintain 80% of its assets and payroll in California, as required under R&TC Section 18152.5.

The taxpayer filed a protest asserting, *inter alia*, that the California QSBS statute unfairly discriminated against investors in companies which conduct a portion of their business outside of California. The FTB denied the taxpayer's protest, as did the State Board of Equalization after the taxpayer paid the tax and appealed. He filed an action in state trial court where the trial judge granted the FTB's summary judgment motion. Despite these losses, the taxpayer persevered and, in an unusual decision, won on the commerce clause argument before the California Court of Appeal for the Second Appellate district.

The commerce clause of the U.S. Constitution generally limits states' ability to impose taxes designed to benefit in-state economic interests by burdening out-of-state competitors. *Fulton Corp. v. Faulkner*, 516 U.S. 325, 330 (1996). In *Fulton Corp.,* the high court invalidated an "intangibles tax" imposed by North Carolina on a fraction of the value of corporate stock owned by North Carolina residents. The tax was assessed at a stated rate, but residents were entitled to take a deduction based on the percentage of a corporation's income subject to tax in North Carolina.

The *Fulton Corp.* Court found that the intangibles tax discriminated against interstate commerce in violation of the commerce clause. According to the Court, the intangibles tax favored North Carolina corporations over their out-of-state competitors since it taxed stock only to the degree that its issuing corporation was doing business *outside* of North Carolina. 516 U.S. at 333.

Applying *Fulton Corp.*, the California Court of Appeal found that R&TC Section 18152.5 favors investment in corporations doing business within California and operates as a disincentive to buying stock in corporations doing business out of California. Under the statute, California plainly provides preferential tax treatment to QSBS of qualified small businesses doing the majority of their business in California. This intrastate favoritism forced the state court to conclude: "The statute is discriminatory on its face and cannot stand under the commerce clause."

<u>Conclusions and Implications</u>

The holding in *Cutler v. Franchise Tax Bd*. was a victory for the California taxpayer. However, because of material disputes over whether the taxpayer had held the QSBS for the requisite period, the court was unwilling to order the FTB to refund the taxes previously paid.

While *Cutler v. Franchise Tax Bd.* was a victory for a single taxpayer, it leaves many questions unanswered for all other investors holding QSBS or considering investments in small businesses. Clearly, taxpayers should not stop purchasing QSBS or seeking special tax dispensation for such investments. Where the corporations meets the 80% in-state active business and payroll requirements, presumably taxpayers will continue to enjoy the exclusion and deferral provided at R&TC Sections 18152.5 and 18038.5 without change. In cases where the corporation does not meet the requirements, taxpayers may considering arguing that they qualify for the special exclusions, provided their stock meets the many other requirements of R&TC Section 18152.5.

The State of California will inevitably appeal *Cutler v. Franchise Tax Bd*. Whatever the result, taxpayers should be aware of the special exclusions and deferral provided to those who invest in QSBS.

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