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California Qualified Small-Business Stock: Manna From Heaven?

by Mark A. Muntean

Mark A. Muntean is of counsel with Robert W. Wood, San Francisco.

Job 1:24 provides the often-quoted phrase "the Lord giveth and also taketh away." Job endured destruction of his property, loss of his family, and suffered boils all over his body, but at least he was spared from dealing with California on tax issues.

The California Legislature giveth business tax incentives but the state Franchise Tax Board (FTB) taketh those incentives away. That's the way it seems, at least. Indeed, a nearly biblical multitude of California taxpayers can testify to their tortured plight regarding the California manufacturer's tax credit, encouraged by the Legislature and frustrated by the FTB. Similarly, we are now suffering the same course of events in the application of its qualified small-business stock (QSBS) rules.

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In addition to satisfying both the letter and the spirit of the law, clients have asked what more they can do to protect their QSBS exclusions under California law so that the FTB will pass over their state income tax return. Those efforts may be for naught. An FTB auditor recently disclosed that Sacramento has instructed its auditors to examine nearly every tax return that includes an exclusion for QSBS.

A merger (or other transaction that involves the sale of stock) carries an opportunity for tax savings. Internal Revenue Code section 1202 can apply to the stock sale, resulting in the exclusion of gain from income for federal or state tax purposes. IRC section 1202 and California Revenue and Tax Code sections 18152 and 18152.5 allow a taxpayer to exclude 50 percent of any realized gain from the sale or exchange of QSBS the taxpayer has held more than five years.

Under IRC section 1202, the tax treatment of gain on QSBS realized by noncorporate taxpayers differs from gain on other securities transactions. Consistent with other stock transactions, there may be short- or long-term capital gain. However, under IRC section 1202(a), a 50 percent exclusion may apply and a tax-deferral opportunity may exist. Two important issues are the holding period requirements and the effect of the alternative minimum tax.

I. Federal Statutory Requirements

To qualify as QSBS, the stock must be:

1. issued by a C corporation with no more than $50 million of gross assets at the time of issue;

2. of a corporation that uses at least 80 percent of the asset value for active trade or business purposes, other than in the fields of personal services, finance, farming, restaurants or hotels, and so forth;

3. issued after August 11, 1993;

4. held by a noncorporate taxpayer (that is, any taxpayer other than a corporation);

5. acquired by the taxpayer on original issue (though there are exceptions to this rule); and

6. held for more than six months to be eligible for a tax-free rollover under section 1045, and for more than five years for a 50 percent gain exclusion.

The rollover provision has been available for sales after August 5, 1997. Because the corporation must have issued the stock after August 11, 1993, no one could qualify for the exclusion until August 11, 1998. Thus, 1998 state income tax returns filed in 1999 were the first returns to reflect the QSBS exclusion. Such income tax returns are only now working their way through the audit and protest stages with the FTB.

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The 50 percent gain exclusion is generally limited to $5 million per taxpayer per issuer. Thus, a taxpayer normally sells shares with a gain in excess of $10 million and can exclude 50 percent of the gain up to $5 million.

For a corporation's stock to be QSBS, IRC section 1202 provides the following:

(1) At all times after August 10, 1993, and before it issues the stock, the corporation must have aggregate gross assets (as defined below) that do not exceed $50 million.

(2) Immediately after the corporation issues the stock, it must have aggregate gross assets that do not exceed $50 million. For that purpose, amounts received in the issuance are taken into account.

IRC sections 1202(d)(1)(A) and 1202(d)(1)(B). California mirrors these subsections of the IRC in California Revenue and Taxation Code sections 18152.5(d)(1)(A) and 18152.5 (d)(1)(B).

An FTB auditor recently disclosed that Sacramento has instructed its auditors to examine nearly every tax return that includes an exclusion for QSBS.

If a corporation satisfies these gross assets tests as of the date of issuance but later exceeds the $50 million asset threshold, stock that otherwise constitutes QSBS does not lose that character solely because of that later event. But if a corporation or a predecessor corporation exceeds the $50 million asset threshold, it can never again issue QSBS. H. Rept. No. 103-111 (P.L. 103-66), p. 602.

Nonrecognition of gain may be achieved through a partnership, S corporation, regulated investment company, or common trust fund if the entity held the qualifying stock for more than five years and if a taxpayer sharing in the gain held the interest in the passthrough entity at the time the taxpayer acquired the qualifying stock and at all times thereafter.

Not Quite 40 Years in the Desert

The tax consequence of QSBS sold at a gain by a noncorporate investor depends on which of four different holding periods apply:

1. *Holding period of six months or less*. The gain is a short-term capital gain, taxed at individual tax rates. This is not an attractive option unless the gain can be offset with capital losses.

2. *Holding period of more than six months but not more than one year*. The gain is a short-term capital gain, taxed at individual tax rates. However, as an alternative to recognizing short-term gain, the investor may defer the gain by rolling over the investment to other QSBS under IRC section 1045 within 60 days of the sale. As with other nonrecognition sections, the seller recognizes and realizes gain to the extent he retains part of the sales proceeds (boot). The basis of the stock sold becomes the basis of the stock purchased, subject to adjustment (less boot and plus gain recognized), and a taxpayer may tack the holding period of the old stock onto that of the new stock.

3. *Holding period of more than one year but not more than five years*. Any gain recognized is long-term taxed at the maximum rate of 15 percent (5 percent if the investor is in the 10 percent or 15 percent bracket), unless offset by capital losses.

4. *Holding period of more than five years*. Under IRC section 1202, a taxpayer would not recognize long-term capital gain. Instead, a taxpayer is permitted to exclude one-half of the gain recognized (reduced by any gain deferred through a rollover) under section 1202. Of that amount, 7 percent is a preference item for AMT purposes. See IRC section 57(a)(7). The statute places the remaining one-half in the 28 percent tax basket, together with net long-term gains from collectibles and long-term capital loss carryovers.

Thus, the effective overall rate is 14 percent on the entire gain. If, however, the seller is in the top AMT bracket, which is also 28 percent, the effective tax rate is 14.9 percent ((7 percent x 14 percent) + 14 percent). That removes any incentive to qualify for the IRC section 1202 exclusion.

Because of the well-publicized benefit of having stock profits taxed as long-term capital gain, taxpayers are accustomed to thinking of more than one year as the requisite holding period to obtain tax savings. Taxpayers who invest in QSBS should not be misled. If they intend to reinvest their proceeds from the sale of QSBS in other QSBS stock, the relevant holding period is more than six months; passing the one-year mark does not offer an additional benefit.

Also, taxpayers may have been encouraged to purchase QSBS because of the potential for a 50 percent exclusion of gain if they held the stock for more than five years. Taxpayers who are subject to AMT find that benefit of reaching this holding period (rather than the shorter one for long-term capital gain) to be minimal.

Losses on QSBS

Under IRC section 1244, an individual (a more restrictive classification than the noncorporate taxpayer eligibility rule in IRC section 1202) may

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deduct (as ordinary losses) up to $50,000 per year ($100,000 on a joint return) of losses on small-business stock, even if the stock is also QSBS. Only the first $1 million of stock qualifies for ordinary loss treatment. Only the original shareholders are eligible, and an active trade or business must generate more than half the gross receipts. The loss may be a result of a sale, worthlessness, or a liquidation.

II. California QSBS Rules

Instead of conforming to the federal QSBS provisions of IRC section 1202, California has enacted its own similar (but not identical) provisions in California Revenue and Taxation Code sections 18152 and 18152.5.[1] Under the California rules, a taxpayer must have held the stock for five years. There is a lifetime limit on the amount that a taxpayer may exclude as gain for qualifying stock issued by the same issuer: $10 million ($5 million for married individuals filing separately), or 10 times a taxpayer's original basis in the stock of the issuing corporation. To determine the limit for any one individual in later years, gain previously excluded on a joint return will be allocated equally between the spouses for purposes of measuring the limitation.

California Revenue and Taxation Code section 18152.5 requires the corporation to meet an active business requirement during substantially all of a taxpayer's holding period for the stock. The active business requirement is satisfied if 80 percent of the corporation's assets are used, and 80 percent of its payroll is employed, in California during substantially all of a taxpayer's holding period for the stock.

Roll Away the Stone

California did not adopt the federal rollover provision of IRC section 1045 (California Revenue and Taxation Code section 18038.4). Again, with the conviction of Moses, California enacted its own provision, California Revenue and Taxation Code section 18038.5. The California rollover provisions are similar, but the gain must be used to purchase QSBS as defined under California law. For sales after August 5, 1997, noncorporate taxpayers may elect to roll over the gain from the sale of QSBS held for more than six months if the gain is used to purchase other QSBS within 60 days.

If the rollover is elected, a taxpayer recognizes capital gain from the sale only to the extent that the amount realized from the sale exceeds the cost of the stock purchased, reduced by any portion of the cost previously taken into account under that rollover rule. California applies unrecognized gain to reduce (in the order acquired) the basis for determining gain or loss of any QSBS that a taxpayer purchases during the 60-day period. Except for purposes of determining whether the replacement stock meets certain active business requirements during the six-month period following its purchase, the holding period of the replacement stock includes the holding period of the stock sold.

Some nonbelievers might say that the benefit of holding QSBS has declined with falling capital gain rates. In fact, the complexity of the statute, together with modifications in state rules, may offset the benefit that originally existed. Taxpayers need to be creative here. In some cases, a better strategy may be to fail the QSBS test under section 1202. That analysis might be dependent on whether a taxpayer is paying AMT.

> ***Taxpayers need to be creative. In some cases, a better strategy may be to fail the QSBS test under IRC section 1202.***

However, the rollover opportunity might still be significant. If a taxpayer plans to reinvest any proceeds from sale, or if a taxpayer is making another investment that might meet the timing of IRC section 1045 discussed above, it may be worthwhile to consider a rollover.

California's Need to Examine Its People

Many investors acquired their stock from the issuing company as early as 1993 or 1994. Beginning in 1998 and 1999, investors began to divest themselves of their stock, sometimes as a block but more often in a series of sales. It is important for investors to have more than 60 months pass before the first sale of small-business stock. Of course, this is because a taxpayer can exclude 50 percent of any realized gain from the sale or exchange of QSBS held more than five years (60 months) by the taxpayer. See IRC section 1202 and California Revenue and Taxation Code sections 18152 and 18152.5.

The definition of QSBS includes any domestic corporation that is a C corporation if (in addition to other statutory requirements discussed previously) at least 80 percent (by value) of the assets of the corporation are used by the corporation in the active conduct of one or more qualified trades or business in California, and at least 80 percent of the corporation's payroll (as measured by the total dollar value) is attributable to employment in California (California Revenue and Taxation Code section 18152.5(d)(1)).

A QSBS must employ at least 80 percent of the corporation's assets and payroll in one or more trades or businesses in California during substantially all of the taxpayer's holding period for the stock. The California tax law requires the corporation to meet an active business requirement during substantially all of the taxpayer's five-year holding

[1]Table 1 (next page) compares the federal QSBS requirements with the California requirements.

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Table 1

Requirement	Federal Requirements	California Requirements
Entity.	C corporation.	C corporation.
Stock Issued.	By the corporation as original issue.	By the corporation as original issue.
Date Issued.	After August 11, 1993.	After August 11, 1993.
Asset Limitation.	No more than $50 million.	No more than $50 million.
Asset Test.	Use at least 80 percent of its assets in an active trade or business.	Use at least 80 percent of its assets in an active trade or business in California.
"Asset" Defined.	Defined by statute to include gross assets, including current assets and intangible assets.	Defined by statute to include gross assets, including current assets and intangible assets. (The FTB tries to use the Schedule 100R property definition instead of the definition provided by the statute.)
Payroll Test.	No requirement.	Employ at least 80 percent of its total payroll expense in an active trade or business in California. (The FTB tries to use "payroll" as defined in the California Schedule 100R instead of the term used in the statute.)
Qualification Period.	During substantially all of the 60-month holding period.	During substantially all of the 60-month holding period. (State Board of Equalization precedent defines substantially all to mean 80 percent or more; however, the FTB argues for a higher percentage.)
Holder.	Noncorporate taxpayer.	Noncorporate taxpayer.
Holding Period, no rollover.	60 months.	60 months (although on audit, FTB auditors frequently try to apply the asset test and the payroll test over the entire period the taxpayer owns the stock).
Holding Period, if rolled over.	6 months.	6 months.

period for the stock. The active business requirement is satisfied if the corporation employs or uses 80 percent of its assets, and 80 percent of its payroll, in California during substantially all of the taxpayer's five-year holding period for the stock (California Revenue and Taxation Code section 18152.5). California Revenue and Taxation Code section 18152.5(e)(1) provides that:

> For purposes of paragraph (2) of subdivision (c), the requirements of this subdivision are met by a corporation for any period, if during that period both of the following apply:
>
> (A) At least 80 percent (by value) of the assets of the corporation are used by the corporation in the active conduct of one or more qualified trades or business in California.

Therefore, there are three issues that a practitioner must resolve to determine if the taxpayer satisfies the active business requirement:

1. Did the QSBS use 80 percent of its assets in California during substantially all of the taxpayer's five-year holding period for the stock?
2. Did the QSBS employ 80 percent of its payroll in California during substantially all of the taxpayer's five-year holding period for the stock?
3. What is the definition of substantially all for purposes of IRC section 1202 and California Revenue and Taxation Code section 18152.5?

As it happens, these are the most common issues raised in an audit. Each will be discussed separately below.

The term "period" for purposes of the QSBS statute is undefined other than "the taxpayer's holding period for the stock," which is the five-year holding period for qualifying as a qualified small business. (California Revenue and Taxation Code section 18152.5(c)(2)(A)). Section 18152.5(c)(2)(A) specifically provides that:

> Stock in a corporation shall not be treated as qualified small business stock unless, *during substantially all of the taxpayer's holding period for the stock,* the corporation meets the active business requirement of subdivision (e) and the corporation is a C corporation. [Emphasis added.]

Taking Stock of One's Property

In an audit, an FTB auditor will generally attempt to define the term "assets" to mean "property" as the term is used for purposes of the California state franchise tax property factor. The property factor is used as part of the state franchise tax

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apportionment formula for apportioning a corporation's income to California when the corporation does business both inside and outside California.

For franchise tax apportionment purposes, California defines property to mean only the real property and tangible personal property of the corporation (California Revenue and Taxation Code section 25129). This is a very narrow definition of property and certainly is not the definition of assets for QSBS purposes. It omits from the definition all current assets as well as all intangible assets of the corporation.

Under both federal and California law, the term "aggregate gross assets" means the sum of cash and the adjusted basis of other property held by the corporation. IRC section 1202(d)(2)(A). For this purpose, the adjusted basis of any property contributed to the corporation, and of any property whose basis is determined in whole or in part by reference to the adjusted basis of property so contributed, is determined by treating the basis of the contributed property immediately after the contribution as equal to its fair market value at that time. IRC section 1202(d)(2)(B) and California Revenue and Taxation Code section 18152.5(d)(1)(A). However, that definition is broad and encompasses all assets including cash and cash equivalents.

> ***Because the Legislature defines assets broadly to include all assets for purposes of California Revenue and Taxation Code section 18152.5, the use of the term 'property' by the FTB is completely inconsistent with both the statute on its face and with California law.***

Moreover, California defines assets (for purposes of the 80 percent asset test of section 18152.5(e)(1)(A)) to include expenditures for start-up activities and for research as assets used in the conduct of a trade or business. IRC section 1202(e) and California Revenue and Taxation Code section 18152.5(e)(2). Assets held for the working capital needs of the business are also deemed to be used in the active conduct of a trade or business for QSBS purposes. IRC section 1202(e)(6)(A) and California Revenue and Taxation Code section 18152.5(e)(6)(A). That includes assets that are reasonably expected to be used within two years to finance research or increased needs for working capital. IRC section 1202(e)(6)(B) and California Revenue and Taxation Code section 18152.5(e)(6)(B).

Thus, for purposes of IRC section 1202 and California Revenue and Taxation Code section 18152.5, assets are defined as the sum of cash (and cash equivalents) and the adjusted basis of other property held by the corporation, working capital, and expenditures for start-up activities and research. California's tax law conforms to IRC section 1202 for QSBS subject to modifications. However, the California Legislature did not alter the definition of assets under California Revenue and Taxation Code section 18152.5. Because the Legislature defines assets broadly to include all assets for purposes of California Revenue and Taxation Code section 18152.5, the use of the term "property" by the FTB is completely inconsistent with both the statute on its face and with California law.

Because all QSBS corporations are headquartered in California, most current assets and intangible assets would be deemed to be located at the California headquarters of the company. Therefore, the current and intangible assets would be considered used in the business activity in California. Adding the current and intangible assets to the property factor will generally increase the California asset apportionment.

Not the Wages of Sin

As stated above, the active business requirement is satisfied if the corporation employs or uses 80 percent of its assets, and 80 percent of its payroll, in California during substantially all of the taxpayer's five-year holding period for the stock. That requirement does not exist in the federal QSBS statute. IRC section 1202. The provision was drafted by the California Legislature as part of section 18152.5.

Similar to assets, the FTB auditor will want to use the franchise tax apportionment payroll factor as listed to show the percentage of total payroll expense in California for QSBS purposes. As reflected on California Schedule 100R, the payroll factor includes a numerator that is the total amount that an employer pays in California during a tax year as compensation and a denominator that is the total compensation paid everywhere for the same tax year (California Revenue and Taxation Code section 25132; Cal. Code regs. 18 sections 25132(b) and 25132(c)). Total payroll is determined on the basis of a taxpayer's accounting method.

Compensation means wages, salaries, commissions, and any other form of remuneration paid directly to employees for personal services connected with a company's business income (California Revenue and Taxation Code section 25120(c); Cal. Code regs. 18 section 25132(a)(3)). However, California Revenue and Taxation Code section 18152.5 does not use the concept of compensation paid to determine total payroll expense. The statute also does not refer to the Schedule 100R or the payroll apportionment factor in defining total payroll expense.

QSBS used both nonqualified and incentive stock options as significant components of compensation

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to be competitive in the California employment market. Substantial granting and vesting of options occurred during the years 1993 through 2001. Also, payroll expense clearly includes employer taxes, perquisites, and administrative costs. Total payroll expense, as used in California Revenue and Taxation Code section 18152.5, is not equivalent to the term "compensation paid" as explained in the instructions for California Schedule 100R.

Total payroll expense is commonly defined as "compensation earned by employees, irrespective of when paid, including salaries, wages, commissions, bonuses, and other compensation, by an individual who during any years performs work or renders services, in whole or in part."[2]

This is the commonly accepted definition of payroll expense used for payroll tax purposes in California and other states. The definition of total payroll expense is used to determine a taxpayer's payroll within (and outside) the taxing jurisdiction. Therefore, the standard definition is consistent with the legislation's purpose in using the term. There is no need to add an extraneous definition or requirement to the statute derived from franchise and income taxes.

Nonstatutory options are included in W-2 wages when exercised to the extent the fair market value at exercise exceeds the grant price. That compensation is presumably included on California Schedule 100R. However, the vesting of options creates a compensatory benefit, even if the employee defers the exercise and recognition of that benefit.

Incentive stock options result in W-2 income only if the employee fails to meet the holding requirements. Thus, although the employee has been "paid" for services rendered, the specific beneficial tax treatment of incentive options results in no W-2 income, and no "wage" expense for the company.

There is no indication in the legislative history that the legislators intended to disregard incentive options. In fact, because the Legislature modified IRC section 1202 in adding the 80 percent payroll requirement to California Revenue and Taxation Code section 18152.5, it could easily have adopted the payroll amounts as reported on California Schedule 100R in defining total payroll expense. However, that modification was not made and the Legislature's intent may be inferred from the omission.

Because the home office of a QSBS company is in California, the principal officers are usually based there. The vesting and exercise of their options alone constitute substantial California compensation, only a portion of which is reflected in California Schedule 100R. In adding those amounts to the California Schedule 100R payroll amounts, a more accurate total payroll expense for California and everywhere can be calculated.

Using the definition of total payroll expense as provided by the statute, rather than California Schedule 100R, most QSBS companies will satisfy the 80 percent test for more than the 60-month holding period, meaning more than 80 percent of QSBS's payroll is employed by the corporation in the active conduct of one or more qualified trades or businesses in California.

A Good-Sounding *Cantor*

As stated previously, California Revenue and Taxation Code section 18152.5 requires the corporation to meet an active business requirement during substantially all of the taxpayer's holding period for the stock. The active business requirement is satisfied if 80 percent of the corporation's assets are used, and 80 percent of its payroll is employed, in California during substantially all of the taxpayer's holding period for the stock.

The term "substantially all" is used more than 100 times in the Internal Revenue Code, nearly always without definition. Auditors have selected random IRC provisions, in which the term "substantially all" is defined as an amount greater than 80 percent. For example, auditors have referred to IRC section 4041, which regards enterprise zones.

In much the same way, a taxpayer can cite several IRC sections in which "substantially all" is defined as at least 80 percent. For example:

1. In IRC section 368, "substantially all" is defined as at least 80 percent (Treas. Reg. section 1.368-2(d)(2)).

2. In IRC section 1400L, regarding New York Liberty Zone business credits, "substantially all" is defined as 80 percent or more (see IRS Notice 2002-42, Q&A 4, 2002-27 IRB 6).

3. Under IRC section 170, regarding corporate charitable contributions of scientific property for use in research experimentation or training, "substantially all" is defined to mean at least 80 percent (S. Rep. 97-144, P.L. 97-44, p. 89).

4. IRC section 302 describes "substantially disproportionate" as less than 80 percent.

Indeed, California also defines the term "substantially all" as at least 80 percent (and, in fact, less than 80 percent in some cases):

- For a sale or reorganization of a business, in which the business transfers all, or substantially all, of the property of the business, for purposes of California Revenue and Taxation Code section 6006, California defines substantially all as 80 percent or more.

[2]The term "total payroll expense" is also defined for generally accepted accounting procedures more broadly than payroll for purposes of Schedule 100R. However, the FTB has refused to consider this definition.

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- In California Revenue and Taxation Code section 20509, "substantially equivalent" is defined as at least 80 percent. *In the Matter of Helen Cantor, Betty M. Asman, and Yakov Kras,* 2002 SBE 008 (Nov. 12, 2002)(discussed below).
- Cal. Code Regs., Title 18, section 1595(b)(2) defines the term "substantially all" to mean at least 80 percent.
- In California Revenue and Taxation Code section 23251, "substantially all," for control purposes, is defined as the transfer of at least 80 percent of the properties of another corporation.
- California Revenue and Taxation Code section 24451 describes "substantially disproportionate" as less than 80 percent.

The California State Board of Equalization (BOE) was recently faced with a similar issue in *Matter of Helen Cantor, Betty M. Asman, and Yakov Kras,* 2002 BOE 008 (Nov. 12, 2002). (For the BOE's ruling in *Cantor,* see *Doc 2002-27342* or *2002 STT 246-6*). In *Cantor*, the BOE reviewed the definition of "substantially equivalent" in the context of California Revenue and Taxation Code section 20509, regarding payments in lieu of property taxes. In *Cantor* the term "substantially" was not defined by the statute. The BOE sought to define the term by looking to federal and California definitions of "substantially all." The BOE analyzed the authority in that area as follows:

> Having narrowed our definition of "substantially equivalent" for purposes of section 20509 to a numerical definition of something less than 100 percent, we will provide a brief review of other sources that discuss the word "substantially" in numerical terms.
>
> *California tax law*: A property tax statute relating to the lease-leaseback of publicly owned property defines the term "substantially all" to mean at least 85 percent. (Revevue & Taxation Code, § 107.8, subd. (b)). In a sales and use tax statute defining "sale" and "purchase" at a social gathering, "substantially all" is defined as 80 percent or more. (Rev. & Tax. Code, § 6010.30, subd. (b).) In a sales tax regulation relating to the transfer of business property, "substantially all property" means 80 percent or more. (Cal. Code Regs., Title 18, § 1595, subd. (b)(2).)
>
> *Other California law*: In determining whether a conditional sales agreement existed on an automobile, lease payments totaling 75 percent of the value of the vehicle were not "substantially equivalent" to the value. (*Estate of Gonzalez* (1990) 219 Cal. App.3d 1598.) For purposes of determining whether an election was required to approve a municipal annexation, a plot of land was "substantially surrounded" by an annexing city where 98 percent of the land was surrounded by the city. (*Fig Garden Park No. 2 Assn. v. Local Agency Formation Comm.* (1984) 162 Cal. App.3d 336.) Three different plots of land were "substantially surrounded" by an annexing city where 79.8 percent, 89.1 percent, and 82.4 percent of the respective plots were surrounded by the city. (*Scuri v. Board of Supervisors* (1982) 134 Cal. App. 3d 400.)
>
> *Federal tax law*: For purposes of certain corporate reorganizations under Internal Revenue Code (IRC) section 368, a transfer of "substantially all" of a corporation's property may be satisfied by a transfer of 80 percent of fair market value. (Treas. Reg., § 1.368-2(d)(2).) For purposes of the IRC section 521 tax exemption for farmers' cooperatives, shareholder-producers who own 85 percent of the voting stock own "substantially all" of the cooperative. (Rev. Rul. 73-248, 1973-1 CB 295.) The IRC section 521 "substantially all" requirement was met by 91 percent ownership, but not by 72 percent ownership. (*Farmers Cooperative Creamery v. Commissioner*, (1930) 21 BTA 265; *Petaluma Cooperative Creamery v. Commissioner*, (1969) 52 TC 457.)
>
> Considering the above-cited statutes, regulations, and cases that have applied the word "substantially" in other areas of law, we find that "substantially equivalent," as used in section 20509, can be reasonably defined as at least 80 percent. We believe this definition is consistent with the common and legal uses of the word "substantially," as well as with the general structure and purpose of the HRA law.

2002 SBE 008 (Nov. 12, 2002). The analysis in the present case would be extremely similar to the BOE's analysis in *Cantor*. Thus, California has defined the term "substantially all" as in the upper 70 percent range (more than 75 percent in *Estate of Gonzalez, supra*).

Using the BOE's analysis in the case of California Revenue and Taxation Code section 18152.5, the BOE would likely conclude that the term "substantially all" could be reasonably defined as at least 80 percent. Accordingly, under that analysis, QSBS clearly met the active business requirement under the statute, because 80 percent of the assets and payroll were used or employed in California during all of the five-year holding period. As such, QSBS qualified as a qualified small business. Thus, a taxpayer's shares of QSBS qualified as QSBS, and 50 percent of the gain realized by a taxpayer is properly excluded under California law.

III. Legislative History

The FTB's interpretation of California Revenue and Taxation Code section 18152.5 is inconsistent with California Revenue and Taxation Code section

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18152.5's legislative history. Lawmakers intended to avoid litigated cases, encourage investment, and avoid unnecessary complexity.

Avoiding Strife

The California Legislature had great concern that California Revenue and Taxation Code sections 18152 and 18152.5 not result in heavily litigated cases. That legislative history specifically states that the "FTB staff will work with all interested parties to assure that this bill does not lead to results similar to those arising from the date of acquisition issue in the context of the decision in *Appeals of Diane L. Morris Trust, et al.,* 89-SBE- 019."

The FTB's interpretation of California Revenue and Taxation Code section 18152.5 is inconsistent with California Revenue and Taxation Code section 18152.5's legislative history. Lawmakers intended to avoid litigated cases, encourage investment, and avoid unnecessary complexity.

Throughout the various versions of AB 44 — that is, SB 1018, AB 2268, and AB 3215 — the legislative history was clear that the statutes were intended to be enacted in a manner that would not lead to confusion or extraneous litigation.

The Legislature worked toward approving legislation that was easily discerned and with which a taxpayer could easily comply. The Legislature clearly did not contemplate that a taxpayer would be prevented from satisfying the requirements of California Revenue and Taxation Code section 18152.5 merely because of an unreasonable FTB interpretation. The Legislature was interested in having companies grow and become profitable, and it did not intend for the statute to hamstring companies in order for its founders to achieve the tax benefit promised by this statute.

The FTB interpretation of the terms "assets" (despite its actual definition in the statute itself), "payroll," and "substantially all" are too narrow. This interpretation frustrates the intent of the Legislature to avoid unnecessary litigation. If the FTB adopts a more reasonable interpretation of assets, payroll, and "substantially all" that is consistent with California law, litigation can be averted.

Encouraging Investment

In the legislative history it is well-documented that the legislative intent was to "encourage investment in growing California companies and to provide incentives for California investment."

To be consistent with the intent of California Revenue and Taxation Code section 18152.5 — that is, to encourage investment in growing California companies (see Assembly Third Reading, p. 2) and to ensure its intended application — the FTB is obligated to apply the statute in a manner that would be consistent with other statutes that are intended to provide similar benefits to a taxpayer, that is, IRC section 1202.

In the *Appeal of Save Mart Supermarkets & Subsidiary*, 2002-SBE-002 (Feb. 6, 2002), in the context of the manufacturer's tax credit (a similar business tax incentive statute), the BOE said:

> As a basis for our conclusion, we rely on several considerations. First, we believe the Manufacturers' Investment Credit should be interpreted liberally in favor of taxpayers. This goal is not accomplished by the multitude of requirements for determining a qualified taxpayer set forth in the regulation, which eliminate its applicability to large segments of manufacturing jobs. Second, respondent's regulatory scheme contributes unnecessary complexity to an already complex statute. Third, and most importantly, the language of R&TC section 23649, subdivision (c)(1), does not contemplate or require the incorporation of the entire SIC Manual classification scheme in order to define a qualified taxpayer. *Appeal of Save Mart Supermarkets & Subsidiary*. (For the BOE's ruling in *Save Mart Supermarkets,* see *Doc 2002-3633* or *2002 STT 33-6*.)

To be consistent with the above holding in *Save Mart*, the FTB must recognize that the statute itself has a multitude of requirements that are, on their face, easily interpretable — for example, a five-year holding period and 80 percent of payroll must be in California, etc. However, the "substantially all" requirement has no expressed definition and, therefore, is the area wherein the FTB's efforts need to be asserted to ensure that the purpose of the legislation is effectuated.

> According to the author, this measure is intended to encourage investment in growing California companies by reducing the capital gains generated by investments in qualified companies. The author believes that smaller, venture capital companies are the primary producers of new jobs in California. AB 44.

Therefore, the FTB should interpret the terms "assets," "payroll," and "substantially all" in a reasonable manner to be consistent with the intent of the legislative intent behind the statute. The FTB must revisit its interpretation and provide a result that alleviates an unreasonable burden on the taxpayer and promotes the intent of the legislation.

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IV. Rollover and Reinvestment

As discussed previously, IRC section 1045 and California Revenue and Taxation Code section 18038.5 provide for the deferral of gain from the sale of QSBS when replacement QSBS is acquired. A taxpayer may elect to defer the gain, to the extent that a taxpayer acquires any QSBS, within 60 days from the sale.

When replacement stock is purchased within 60 days of the sale of the QSBS, satisfying the statute, but the taxpayer fails to label the replacement stock as IRC section 1045 or California Revenue and Taxation Code section 18038.5 rollover stock on the income tax return, on audit California auditors will disregard the rollover election. California auditors will generally disallow rollover treatment and refuse to permit the taxpayer to file an amended return correcting the election.

IRS Rollover Rules

Because IRS Rev. Proc. 98-48 allows taxpayers to make a rollover election either on an original return or an amended return, taxpayers should be allowed to file an amended return to make a correction to a date listed, in the original election, on the California income tax return.

Indeed, IRS Rev. Proc. 98-48 does not specify that the taxpayer is required to report the date of the rollover, *nor* the date of the sale related to when the QSBS rolled over. The transition rules under Rev Proc. 98-48 provide:

> (2) Transition Rule. If gain is reported on a return filed before October 21, 1998, and the return does not satisfy the requirements of Section 3.02(1) of this revenue procedure but discloses the gain and includes an affirmative statement to the effect that a Section 1045 election applies, to the gain, the requirements of Section 3.02(1) will be treated as satisfied and an amended return is not required to make the Section 1045 election. Otherwise an original return or an amended return satisfying the requirements of Section 3.02(1) of this revenue procedure is required to make the Section 1045 election with respect to such gain.

FTB Rollover Rules

The FTB has adopted the IRS rules and procedures relating to QSBS and qualified rollovers, stating that:

> Due to their similarity and the express intent of the Legislature, any federal rules or procedures applicable to the federal qualified small business stock provisions apply to California's qualified small business stock provisions to the extent that they do not conflict with any California rules or procedures.

FTB Notice 2003-6, citing California Revenue and Taxation Code section 18152.5. As such, Rev. Proc. 98-48 is applicable to a taxpayer's California personal income tax return.

FTB Notice 2003-6 sets special procedures for taxpayers to defer their gains from the sale of QSBS made after August 5, 1997. FTB Notice 2003-6 states that for tax years ending before May 8, 2002, a taxpayer may make an election under California Revenue and Taxation Code section 18038.5 to roll over its gain from the sale of QSBS by filing an amended return on or before the earlier of the date of the expiration of the statute of limitation on assessment, or claim for refund, for that tax year.

Under the notice, the election may be made by reporting the amount to be deferred on California Schedule D and writing "section 18038.5 election." Also, a taxpayer must write "filed pursuant to FTB Notice 2003-6" at top of the amended return.

The notice further states that this special procedure implements the legislative intent to apply 2002 legislation that expanded the types of eligible taxpayers from "individuals" to "taxpayers (other than corporations)," for QSBS sales made after August 5, 1997. Notably, the 2002 statute was not enacted until May 8, 2002, causing taxpayers to be unable to properly elect the benefits of California Revenue and Taxation Code section 18038.5 on their original returns, because they lacked the statutory authority to do so before the 2002 amendment.

Thus, when the taxpayer reinvests the gain in a qualifying small business as required by the statute, and the only issue is whether the election does not reference the correct date of sale, an amended return is allowed under IRS procedures (adopted by the FTB) to remedy the situation. For that reason, a taxpayer should be permitted to file an amended return to clarify the correct date, and the rollover should be respected. Because FTB Notice 2003-6 allows a taxpayer to make a rollover election on either an original return or an amended return, a taxpayer should be allowed to file an amended return to make a correction to a date listed on the original rollover election on the California income tax return.

Fear Not

If your client claims a QSBS exclusion or makes a rollover election, he may be audited by the FTB. However, fear not. Many of the objections made by the auditor can be overcome on protest. What angers clients about this approach is that they feel they have followed the rules and the state is unfairly seeking taxes from them. However, patience and perseverance can pay off in the end. ✰

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