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UPDATE ON QUALIFIED SMALL BUSINESS STOCK: NEW FEDERAL LEGISLATION AND STATUS OF CALIFORNIA RULES

Eligible investors in qualified small businesses are entitled to certain tax benefits that, with recent federal legislative changes, have become more attractive. Under a special provision of the Internal Revenue Code, certain holders of "qualified small business stock" ("QSBS") can, depending on the issue date of the stock, exclude some, or potentially up to all, of the gain from taxation (depending on the circumstances, and subject to limitations) realized on the sale of QSBS if, among other requirements, the stock is held for more than five years.[1] For QSBS that was acquired at original issue on or before February 17, 2009, the gain exclusion is generally 50 percent (increased to 60 percent in certain limited circumstances); for QSBS that was acquired at original issue after February 17, 2009 and on or before September 27, 2010, the gain exclusion was increased to 75 percent; for QSBS that was acquired at original issue after September 27, 2010 and before January 1, 2012, the gain exclusion was further increased to 100 percent. A companion federal provision entitles holders of QSBS to defer federal income tax on the disposition of QSBS by "rolling over" any gain into purchases of stock in other qualified small businesses.[2] Unlike many other states that have adopted a conformed version of the federal QSBS statute into state law, California has adopted a modified form of the federal QSBS rules supplemented with a few California-specific requirements.[3]

Several recent developments discussed below have expanded the federal but curtailed the California benefits associated with QSBS investments. First, recently enacted federal legislation intended to stimulate investment in small businesses not only extends the time frame for stock issuances that would qualify for the 100 percent exclusion, but also further enhances the value of this exclusion through increases in otherwise applicable federal tax rates. Second, a recent California appellate decision declaring unconstitutional certain aspects of the California version of the QSBS statute has been interpreted by the California Franchise Tax Board (the "FTB") as invalidating the entire statute, leading the FTB to deny QSBS benefits

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entirely to taxpayers for whom the applicable statute of limitations period remains open.

BACKGROUND ON QSBS

The QSBS rules are intended to spur investment in certain small businesses by affording investors the opportunity to exclude or defer some or all of their gain from the disposition of QSBS. There are many requirements that must be satisfied for stock to qualify as QSBS, including the following:

- The stock must be issued by a domestic "C" corporation. Stock issued by certain types of corporations, such as regulated investment companies, real estate investment trusts, real estate mortgage investment conduits, and cooperatives, is not eligible for QSBS treatment.
- The aggregate gross assets of the corporation (generally measured by reference to the tax basis of the corporationís assets) cannot exceed $50 million at any time between August 10, 1993 and the time immediately after the subject stock issuance.
- The holder of the stock cannot be a corporation.
- The holder of the stock must (subject to limited exceptions) acquire it at original issuance and must hold it for more than five years.
- The issuing corporation cannot have engaged in certain purchases and redemptions of its stock in close proximity to the issuance of the QSBS.
- For substantially all of the investor's holding period in the QSBS, at least 80 percent of the issuing corporation's assets (measured by value) must be used by such corporation in one or more "qualified" trades or businesses. A "qualified" trade or business, for this purpose, generally means any trade or business *other than* the following:
  - ➢ Any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any other trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees;
  - ➢ Any banking, insurance, financing, leasing, investing, or similar business;
  - ➢ Any farming business (including the business of raising or harvesting trees);
  - ➢ Any business involving the production or extraction of products of a character with respect to which a deduction is allowable; and
  - ➢ Any business of operating a hotel, motel, restaurant, or similar business.

The aggregate amount of gain for any taxpayer with respect to an investment in any particular issuing corporation that may qualify for the gain exclusion is generally limited to the greater of $10 million or 10 times the taxpayer's aggregate "tax basis" in the issuer's QSBS. For a taxpayer who invests cash in QSBS, the tax basis would generally be equal to the taxpayer's cash purchase price. However, a special rule is provided for purposes of this provision in cases where a taxpayer purchases QSBS for property other than cash. In such cases, the taxpayer's tax basis in the QSBS is deemed to be the fair market value of the property transferred for such QSBS.

If a sale of QSBS cannot qualify for gain exclusion because the seller has not held the QSBS for more than five years, a taxpayer may nonetheless be able to defer gain on such sale under the QSBS gain deferral rules. Subject to certain restrictions, gain from the disposition of QSBS held for more than six months may be used to acquire new QSBS within 60 days following the sale. "Rolling over" gain into new QSBS allows the taxpayer to defer tax on the initial disposition. Furthermore, when QSBS is sold and reinvested in this fashion, the holding period of the old QSBS is generally added to the holding period of the new QSBS, making it easier for taxpayers to ultimately satisfy the five-year holding period requirement for the QSBS gain exclusion.

FEDERAL LEGISLATION

The federal QSBS provisions were amended in 2010 in a manner that greatly expanded the federal tax benefits applicable to gains from QSBS. The 2010 amendments allowed for an exclusion of 100 percent of the gain realized—for both regular tax and alternative minimum tax purposes—from the sale of QSBS if, among other requirements, the QSBS was acquired at original issue after September 27, 2010 and

before January 1, 2012. QSBS acquired on or after January 1, 2012 was no longer eligible for the 100 percent exclusion.

On January 2, 2013, President Obama signed into law the American Taxpayer Relief Act of 2012, which extended and renewed the 100 percent gain exclusion. Under this legislation, a taxpayer may exclude, for both regular federal income tax and AMT purposes, 100 percent of the gain realized on the sale of QSBS held for more than five years and acquired at original issuance *after* September 27, 2010 and *before* January 1, 2014. Notably, the extended 100 percent exclusion period applies retroactively to QSBS acquired at any time during 2012.

The attractiveness of QSBS investing has been enhanced by two other federal tax law changes:

- Beginning in 2013, the maximum long-term capital gains rate for individuals has been increased from 15 percent to 20 percent. Previously, taxpayers subject to the maximum long-term capital gains rate received a relatively small benefit investing in QSBS: a single percentage point reduction in their capital gain tax rate, from 15 percent to 14 percent.[4] With the increase in the capital gain rate to 20 percent, the difference grows to 6 percent.
- Also beginning in 2013, a new 3.8 percent Medicare tax on net investment income has been introduced. While gain from the dispositions of stock by individuals would ordinarily be subject to the additional 3.8 percent Medicare tax, dispositions of QSBS qualifying for exclusion or deferral should not be.

CALIFORNIA RULES

California does not conform to the federal QSBS rules but has its own gain exclusion provision for sales of California QSBS. Unfortunately, the validity of the California QSBS rules is in serious doubt after a recent decision by the California Court of Appeal and positions subsequently taken by the FTB.

The California QSBS statute largely follows the federal QSBS legislation, but it contains additional California-centric provisions. Under the California statute, a taxpayer may exclude 50 percent of any qualifying gain (or, in certain specified circumstances, 75 percent) for California personal income tax purposes, provided that during substantially all of the taxpayer's holding period:

- At least 80 percent (by value) of the corporation's assets were used in the active conduct of one or more qualified trades or businesses in California; and
- No more than 20 percent of the corporation's total payroll expense was attributable to employment located outside of California.

The recent investor-favorable changes to federal legislation discussed above do not apply for California personal income tax purposes. Moreover, the gain excluded is treated as a preference item for California alternative minimum tax computation purposes.

In August 2012, the California Court of Appeal held that the California-centric provisions described above discriminate against interstate commerce in violation of the Commerce Clause of the U.S. Constitution.[5] The FTB has concluded that the valid provisions in the QSBS statute cannot be sustained by severing the invalid provisions therefrom; as a result, the *entire* California QSBS statute is invalid and unenforceable. Accordingly, the FTB has announced it will deny any QSBS gain exclusion or deferral claimed for tax years beginning on or after January 1, 2008. For those taxpayers who have already received the benefits of the QSBS gain exclusion or deferral in any of tax years 2008–2011, the FTB plans to issue Notices of Proposed Assessment beginning in early April 2013.

However, in reaction to vocal taxpayer opposition to the FTB's stance, some lawmakers have promised to craft a remedy different from the FTB's approach. It is unclear whether any such legislation will be enacted, and if so, what it will provide. Nevertheless, the FTB has responded by announcing it will defer issuing Notices of Proposed Assessment to taxpayers who sign waivers of the applicable statute of limitations on assessment. This will allow time for the Legislature to enact a taxpayer-favorable remedy that may reduce the amount of, or possibly the need for, Notices of Proposed Assessment.

PLANNING OPPORTUNITIES FOR THE REMAINDER OF 2013

The 100 percent federal income tax gain exclusion for QSBS is a potential tax benefit that remains significant notwithstanding the current uncertainty surrounding the California situation. The benefit is accentuated by the increase in long-term capital gain rates from 15 percent to 20 percent and the introduction of the 3.8 percent Medicare contribution tax beginning in 2013. As a result, any noncorporate investors who are considering making investments in one or more qualified small businesses during 2013 (or perhaps who may have already done so during 2012) should carefully examine the requirements of the QSBS tax rules to determine the extent to which these rules may apply to their particular transaction.

Investments made in the form of convertible debt, bridge loans with warrants, or similar structures should allow for the possibility of converting such investment into stock prior to year-end in order to qualify for the potential 100 percent federal tax exclusion applicable to stock issued prior to January 1, 2014. Although the QSBS tax rules have been extended in the past (and notwithstanding proposals to make these rules permanent), there can be no assurance that such extensions will continue in the future.

In addition, existing operating companies that are currently treated as partnerships for income tax purposes (such as some limited liability companies) might consider the extent to which the QSBS rules may apply to them. Although the QSBS tax rules apply only to gains from the sale of stock, an LLC that converts to a corporation may allow for QSBS benefits to extend to its shareholders with surprising results. Consider the following:

> **Example:** Assume that an entrepreneur previously organized a new business venture as an LLC, investing a small amount of his own cash and personal "sweat" equity toward the development of the business. Assume also that during 2013, at a time when the fair-market value of the LLC's assets, consisting primarily of valuable trade secrets, patents, and other IP, is $5 million, the entrepreneur converts his LLC into a corporation, thereby exchanging his LLC membership interests for newly issued stock in the corporation. This newly issued stock can potentially qualify as QSBS, and the entrepreneur can potentially qualify for the 0 percent federal tax rates on subsequent sale of his stock if held for more than five years. Moreover, the aggregate amount of gain that the entrepreneur can qualify for this 0 percent federal tax rate would be the greater of $10 million or 10 times his "basis" in such stock (his "basis," for this purpose, being $5 million). Under these facts, the amount of gain potentially qualifying for this 0 percent federal income tax rate would be $50 million (i.e., 10 times $5 million).6 It is interesting to note that, had the entrepreneur organized his venture as a corporation from the outset, the amount of gain potentially available for this exclusion would be only $10 million.

CONCLUSION

The extension of the federal 100 percent gain exclusion is a welcome development, although the federal QSBS rules are complicated and, in several critical places, vague. With the increase in maximum long-term capital gains tax rates and the introduction of the 3.8 percent Medicare tax, the QSBS gain exclusion and deferral provisions are increasingly attractive propositions for eligible investors.

The FTB has taken the position the California QSBS rules are invalid and unenforceable for tax years beginning on or after January 1, 2008, although some lawmakers have promised to introduce taxpayer-favorable legislation. It is unclear at this time whether any such legislation will ultimately be enacted, and if so, what it will provide.

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ENDNOTES

1 Internal Revenue Code §1202.

2 Internal Revenue Code §1045.

3 Revenue & Taxation Code §§18152, 18152.5 and 18038.

4 Although 50 percent (or, in certain circumstances, 60 percent or 75 percent) of the gain from QSBS sales could be excluded from regular federal income tax, the remaining portion of such gain was subject to a maximum federal capital gains rates of 28 percent, rather than what was then a general 15 percent rate otherwise applicable to long-term capital gains. Taking into account the AMT, the benefit of QSBS investing was even less.

5 *Cutler v. Franchise Tax Bd.*, 2012 Cal. App. LEXIS 924 (Cal. App. 2d Dist. Aug. 28, 2012).

6 Upon a subsequent sale of this stock by the entrepreneur, the first $5 million of gain would be taxable at regular federal capital gains rates, with the next $50 million above that amount being eligible for the 0 percent federal rate.

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