How Should California Policymakers Respond to *Cutler*?

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The decision of the Court of Appeal in *Frank Cutler v. Franchise Tax Board*[1] has produced a firestorm in California, with the Franchise Tax Board announcing that it would respond by sending tax deficiency notices to all taxpayers who had relied on the California qualified small business stock (QSBS) investment incentive and sold their QSBS stock, beginning with 2008. This article reviews the position of the FTB and concludes that the QSBS statute can be saved under an *Abbott Laboratories* analysis. Further, the provision in the QSBS statute that defines a qualified small business as a company that has at least 80 percent California payroll at the time of investment will withstand a challenge that it, too, discriminates against interstate commerce, because it does not coerce the corporation in which the investment is made to avoid commerce outside the state.

Background

California Revenue and Taxation Code section 18152.5 allows individual taxpayers to exclude from personal income tax 50 percent of the gain (up to a lifetime limit of $10 million) recognized on the sale of QSBS. The statute is nearly identical to section 1202 of the Internal Revenue Code, except that it contains three California-centric requirements:

(1) a requirement that, when *the stock was issued* at least 80 percent of the corporation's payroll was in California (payroll at issuance requirement);

(2) a requirement that, *during substantially all of the taxpayer's holding period* of the subject stock at least 80 percent (by value) of the corporation's assets was used in the active conduct of one or more qualified trades or businesses in California; and

(3) a requirement that, *during substantially all of the taxpayer's holding period* of the subject stock, at least 80 percent of the corporation's payroll expense was attributable to employment in California.

In *Cutler,* the California Court of Appeal held the 1atter two requirements (which the Court called the "property and payroll requirements") discriminated against interstate commerce in violation of the commerce clause of the U.S. Constitution. The court did not consider the constitutionality of the payroll at issuance requirement.

The Law — How Must the FTB Respond to *Cutler*?

The California Constitution prohibits an administrative agency, such as the FTB, from declaring a statute unconstitutional[2] or from declaring a statute unenforceable or refusing to enforce a statute, on the basis of it being unconstitutional, unless an appellate court has made a determination that such statute is unconstitutional.[3]

Futher, Section 17033 states:

> If any chapter, article, section, subsection, clause, sentence or phrase of this part which is reasonably separable from the remaining portions of this part, or the application thereof to any person, taxpayer or circumstance, is for any reason determined unconstitutional, such determination shall not affect the remainder of [the California personal income tax law], nor, will the application of any such provision to other persons, taxpayers or circumstances, be affected thereby.

This "severability of law" provision is designed to salvage, to the extent possible, any personal income

[1]208 Cal. App. 4th 1247 (2012).

[2]Cal. Const., Art. III, section 3.5(b).
[3]Cal. Const., Art. III, section 3.5(a).

tax statute that is adjudged to include an unconstitutional provision. The court of appeal has made it clear, however, that a severability clause, such as section 17033, does not apply simply because the offending language is mechanically severable from the statute.

In *Farmer Bros. Co. v. FTB*,[4] the California Court of Appeal held that section 24402 violated the commerce clause by allowing a corporate taxpayer a "dividends received deduction," or DRD, but only if the dividend-paying corporation was subject to California tax. On the heels of *Farmer Brothers,* the taxpayer in *Abbott Laboratories v. FTB*,[5] argued that the DRD provided by section 24402 could be preserved by applying section 23057 (the franchise and income tax equivalent of section 17033) to sever the invalid California-centric portion of the law. The court rejected the taxpayer's position, explaining that while a severability clause, such as section 23057, normally calls for severing the invalid portion of the law and sustaining the remaining valid portion of the law, its application turns on whether the invalid provision is grammatically, functionally, and volitionally severable. The court concluded the California-centric DRD limitation was not volitionally severable, because the legislative history of section 24402 reveals a legislative intent to permit a DRD only to the extent the dividends were based on business done in California. It was thus not possible to remove the invalid limiting language without imparting a purpose to the revised statute quite different from the purpose of the originally enacted statute.

The FTB must consider whether the specific parts of the QSBS statute held unconstitutional by the* Cutler *court are grammatically, functionally, and volitionally severable.

Consistent with the clear mandate of *Abbott Labs,* the FTB must consider whether the specific parts of the QSBS statute held unconstitutional by the *Cutler* court are grammatically, functionally, and volitionally severable. The offending portions of the property and payroll requirements at issue in *Cutler* are:

(1) the phrase "in California" in section 18152.5(e)(1)(A); and

(2) all of subsection (9) of section 18152.5(e).

It is readily apparent that both are grammatically and functionally severable from the remainder of the statute. As discussed below, review of the legislative history of the QSBS statute reveals that this language is also volitionally severable, as the "remainder of the statute (1) is complete in itself and would have been adopted by the legislative body had it foreseen the statute's partial invalidation, or (2) comprises a completely operative expression of legislative intent."[6]

The FTB Response to *Cutler* to Date

Shortly after *Cutler* became final, the FTB issued FTB Notice 2012-03, wherein the FTB announced that because the QSBS statute had been held unconstitutional, the statute was invalid and unenforceable.[7] Further, because *McKesson Corp. v. Florida Alcohol & Tobacco Div.*[8] requires that any "remedy" to an unconstitutional statute place similarly situated taxpayers in the same position, the FTB announced that it would adopt the following as its post-*Cutler* "remedy":

- for years beginning before 2008 (that is, years otherwise barred by the general four-year statute of limitations on assessment), the FTB will allow the QSBS gain exclusion or deferral benefit to all taxpayers who meet the requirements of the QSBS statute, other than the unconstitutional California property and payroll requirements; and
- for years beginning on or after January 1, 2008, the FTB will disallow all such exclusion or deferral benefits. The FTB further announced that notices of proposed assessment will be issued denying the exclusion or deferral benefits to all taxpayers who received such benefits in any of calendar years 2008-2011.

FTB Notice 2012-03 does not adequately explain why it is that the FTB does not believe the offending language in the property and payroll requirements can be severed and the remaining portion of the QSBS statute sustained. Instead, it skips right over the *Abbott Labs* severability analysis and, citing *River Garden Retirement Home v. Franchise Tax Board*,[9] focuses instead on applying a "remedy" in response to what it deems a wholly invalid statute.

On February 25, Selvi Stanislaus, executive officer of the FTB, wrote a letter (the "FTB Letter") to the Honorable Henry T. Perea, wherein she explains the FTB believes that the constitutionally infirm property and payroll provisions are not volitionally severable.

Stanislaus states that section 17033:

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[4] 108 Cal. App. 4th 976 (2003).
[5] 175 Cal. App. 4th 1346 (2009).
[6] *Abbott Labs* at 1358.
[7] FTB Notice 2012-03.
[8] 496 U.S. 18 (1990).
[9] 186 Cal. App. 4th 922 (2010).

> requires a determination that the unconstitutional provisions are "reasonably separable" before the rest of an invalid statute can continue to be applied. The case law on severability requires a finding that the Legislature would have enacted those remaining provisions, instead of which it did enact, had the Legislature known the unconstitutional provisions would later be struck down.
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> There is no evidence in this case that demonstrates the Legislature would have done so. Such evidence would be necessary in order for the FTB to have the authority to sever the unconstitutional elements of the invalidated provision.

This position of the FTB is surprising, unless the FTB is mistakenly under the impression that *Cutler* also invalidated the payroll at issuance requirement. When one recognizes that the court of appeal simply did not address the payroll at issuance requirement — so that the FTB when performing its severability analysis is constitutionally bound to treat that provision as part of the "remainder" of the statute — it is crystal clear that the offending language is, in fact, volitionally severable.

As acknowledged by the FTB in FTB Notice 2012-03, the Legislature enacted the QSBS statute with the intent of spurring investment in California small businesses. That intent is advanced not by the offending language in the statute's property and payroll requirements, but by the payroll at issuance requirement, which was not at issue in *Cutler*.

An individual's decision to buy stock is a "one time event" — either the stock is purchased or it is not. It is the act of investment in California-based corporations that the Legislature wanted to encourage when it enacted the QSBS statute, presumably because the Legislature believed those companies were the most likely to spend any such capital investment in ways that would benefit California; for example, by hiring new employees, purchasing or renting new office space, or purchasing products and services from other businesses in the state. The payroll at issuance requirement encourages taxpayers to seek out California-based businesses for investment, and in so doing clearly advances the legislative intent of spurring investment in California.

By contrast, the constitutionally infirm property and payroll requirements actually did little, if anything, to advance the legislative intent of spurring investment in California. This is because corporate operating decisions — such as where to conduct business or whom to hire — are made by the corporation's board of directors or its executive or lower level management, not by its shareholders. The property and payroll requirements actually have nothing to do with encouraging investment *by individuals* in California small businesses. Instead, those provisions focus on the corporation's activities in the years following the investment and produce results that are not at all consistent with the expressed Legislative intent. Consider, for example, the following two hypotheticals.

Hypothetical One: Taxpayer A invests in a California-based corporation that employs five individuals, who all work in a garage in California. During substantially all of the taxpayer's stock holding period, the corporation enjoys respectable growth, adding 10 more employees to its ranks, again all in California. When Taxpayer A sells his stock (assuming all other requirements are satisfied), he will be entitled to the QSBS gain exclusion benefits regarding that stock, because during substantially all of the taxpayer's stock holding period, 100 percent of the corporation's payroll was attributable to employment in California.

Hypothetical Two: Taxpayer B invests in a California-based corporation that employs five individuals, who all work in a garage in California. Despite some early struggles, the corporation ultimately unveils a line of widgets that catapult its business onto the global stage. Over the course of the taxpayer's stock holding period, the corporation, which remains headquartered in California, adds offices and employees all over the United States, Europe, and Asia. During the first seven years of Taxpayer B's 10-year stock holding period, the corporation satisfied the property and payroll requirements in the QSBS statute, but in the last three years of Taxpayer B's 10-year stock holding period, the corporation failed both tests, having only 60 percent of its $500 million asset value located in California, and 75 percent of its payroll expense attributable to employment in California (with 3,000 of its 5,000 employees located in California). When Taxpayer B sells his stock, he will not be entitled to the QSBS gain exclusion benefits regarding that stock because the property and payroll requirements will not have been satisfied during substantially all of his holding period — even though the corporation has $300 million in assets and 3,000 employees in the state.

Did the Legislature really intend to reward Taxpayer A but not Taxpayer B? Of course not, but the poorly drafted property and payroll requirements had that effect. Unlike the unconstitutional California-centric provisions at issue in *Abbott Labs,* it is clear the offending language in the payroll and property requirements of section 18152.5(e) did little, if anything, to advance (and arguably frustrated) the legislative intent of spurring investment in California-based businesses.

That intent is preserved in the valid, remaining portion of the QSBS statute. The *Cutler* court did not strike down the payroll at issuance requirement. Section 17033, thus, must be applied so as to include the payroll at issuance requirement among the valid provisions of the QSBS statute when one applies the three tests for severability outlined in *Abbott Labs.*

It is the payroll at issuance requirement — not the offending property and payroll requirements — that operates to encourage investment in California-based small businesses. Accordingly, a QSBS statute with the payroll at issuance requirement, but without the constitutionally infirm property and payroll requirements (1) is complete in itself and would have been adopted by the Legislature had it foreseen the statute's partial invalidation, or (2) constitutes a completely operative expression of the Legislature's intent. Because the remainder of the statute (1) is complete in itself and would have been adopted by the Legislature had it foreseen the statute's partial invalidation, or (2) comprises a completely operative expression of legislative intent to "give preferential treatment to those investing in small businesses in California versus other states."[10] Thus, the provisions held unconstitutional in *Cutler* are volitionally severable, and the remainder of the QSBS statute continues to be valid and enforceable.[11]

The Payroll at Issuance Requirement Does Not Discriminate Against Interstate Commerce

A question certain to come up is whether the payroll at issuance requirement is itself invalid as a discrimination against interstate commerce. Walter Hellerstein in his treatise *State Taxation* poses the question whether all incentives to engage in commerce in a state are invalid, and concludes that some incentives can survive a commerce clause challenge.[12] Hellerstein concludes that a state tax incentive is invalid only if it implicates the coercive power of the state. Tax incentives should escape invalidation if they are:

> framed not as exemptions from or reductions of existing state tax liability to which the taxpayer would be subjected only if the taxpayer were to engage in the targeted activity in the state. In our view, such incentives neither favor in-state over out-of-state investment (except in a sense that should be constitutionally irrelevant), nor do they rely on the coercive power of the state to compel a choice favoring in-state investment.[13]

Hellerstein then approves of that part of the decision of the U.S. Court of Appeals in *Cuno v. DaimlerChrysler, Inc.*,[14] which upheld the property tax exemption at issue.

The payroll at issuance requirement does not compel the qualified small business to avoid interstate commerce. It thus provided a constitutionally permissible means of encouraging investment in small businesses in California without encouraging or discouraging investment in other states. ✰

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[10]FTB letter, at p. 2.
[11]*See Abbott Labs* at 1358.

[12]Hellerstein, *State Taxation*, at para. 4.14[3][b]; *see also* Walter Hellerstein and Dan Coesnen, "Commerce Clause Restraints on State Business Development Incentives," 81 *Cornell L. Rev.* 789 (1996).
[13]Hellerstein at p. 4, para. 106.
[14]386 F3d 738 (6th Cir. 2004).