

California Court of Appeal Holds Qualified Small Business Stock Gain Deferral Statute Unconstitutional

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Overview

In *Cutler v. California Franchise Tax Board* (“*Cutler*”), the California Court of Appeal recently declared unconstitutional California Revenue and Taxation Code Section (“Section”) 18038.5, which provides capital gain deferral for an individual taxpayer’s sale of stock in certain qualified small businesses.¹ As explained by the court, the deferral statute “favors domestic corporations” (i.e., corporations with 80% of their property and payroll in California) and thus is facially discriminatory in violation of the U.S. Commerce Clause.² This External Alert provides a general background of the statutory provisions at issue, summarizes the appellate court’s analysis, discusses the issues left undecided, and provides some general considerations for taxpayers.

Deferral of Gain on Qualified Small Business Stock - Statutory Background

Section 18038.5 provides elective gain-recognition deferral for individuals on the sale or exchange of qualified small business stock held for more than six months, to the extent the amount realized is used to purchase qualified small business stock within a 60-day period beginning on the date of the sale.³ The terms “qualified small business” and “qualified small business stock” are defined in Section 18038.5(b)(1) by cross-reference to Section 18152.5(c).⁴ These definitional provisions operate to limit gain deferral under Section 18038.5 to transactions where the stock sold and purchased was issued by corporations that used 80% of their assets in the conduct of business in California and maintained 80% of their payrolls in California.⁵ The constitutionality of this 80 percent payroll and property requirement presented the primary issue in the case before the Court of Appeal.

The Court of Appeal Decision

In *Cutler*, the taxpayer sold stock acquired in a start-up company and used some of the proceeds to purchase stock in several other small businesses. The taxpayer deferred a portion of the gain from the sale on his 1998 California tax return under Section 18038.5. The California Franchise Tax Board (“FTB”) disallowed the deferral on the grounds that the stock sold by the taxpayer did not meet the definition of “qualified small business stock” as provided in Section 18152.5(c), and did not meet certain other statutory requirements of Section 18038.5. The taxpayer filed suit in Los Angeles Superior Court, asserting that: (1) the transaction met the statutory requirements, (2) the payroll and property requirement set forth in Section 18152.5(c) was unconstitutional under the U.S. Commerce Clause because it unfairly discriminates against investors in companies that conduct a certain portion of their business outside California, and (3) the Due Process clause of the Fourteenth Amendment required a full refund. The lower court granted the FTB’s motion for summary judgment, finding that the payroll and property requirement was not unconstitutional. The taxpayer appealed the matter to the California Court of Appeal.

On appeal, the FTB argued that the property and payroll requirement does not violate the Commerce Clause because it does not tax out-of-state goods or services and is merely an instance in which California

¹ *Cutler v. California Franchise Tax Board*, No. B233773 (Cal. Ct. App. Aug. 28, 2012), available at: <http://www.courts.ca.gov/opinions/documents/B233773.PDF>.

² *Cutler*, slip op. at 15.

³ The gain deferral is accomplished by reducing the taxpayer’s basis in the acquired qualified small business stock. See Section 18038.5(b)(3).

⁴ Note that the definitional provisions of Section 18152.5(c) apply also with respect to gain exclusion for the sale of qualified small business stock pursuant to Section 18152.5(a).

⁵ Sections 18152.5(d)(1)(C), (e)(1)(A) & (e)(9).

is using its tax system “to compete with other private entities and states for the limited pool of investment dollars.”⁶ The Court of Appeal dismissed these arguments, noting that tax provisions may be discriminatory without taxing out-of-state goods and services and that a state may only use its taxing system to provide competitive advantage in instances where the state, itself, is a market participant (e.g., the issuance of interest-free state bonds).⁷ Following the reasoning of the U.S. Supreme Court in *Fulton Corp. v. Faulkner*⁸ and subsequent California cases (including *Ceridian Corp. v. Franchise Tax Bd.*⁹ and *Farmer Bros. Co. v. Franchise Tax Bd.*),¹⁰ the Court of Appeal concluded that the property and payroll requirement impermissibly “discriminate[s] between transactions on the basis of an interstate element.”¹¹ Citing the Supreme Court in *Fulton*, the Court of Appeal found that the deferral statute “favors domestic corporations over their foreign competitors in raising capital among [California] residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce.”¹² On this basis, the court held that the deferral statute, by requiring 80 percent of a corporation’s property and payroll to be in California in order for the stock to satisfy the definition of “qualified small business stock,” is “discriminatory on its face and cannot stand under the Commerce Clause.”¹³

Accordingly, the Court of Appeal reversed the trial court’s decision. However, citing the FTB’s claim that the taxpayer did not meet the other requirements of the deferral statute separate from the property and payroll requirement, the court declined to decide whether the taxpayer should be afforded the refund requested or whether some other appropriate remedy, if any, should apply.¹⁴ Instead, the court remanded the case to the trial court for further proceedings.¹⁵

Undecided Issues

As noted previously,¹⁶ the same definitional provisions upon which the property and payroll requirement is derived for purposes of *gain deferral* under Section 18038.5 apply also with respect to qualification for *gain exclusion* under Section 18152.5(a). However, the Court of Appeal’s decision addressed the constitutionality of the *gain deferral* provision under Section 18038.5 only, and the facts before the court did not involve the *gain exclusion* provision under Section 18152.5(a). Thus, the court’s decision did not address whether the property and payroll requirement would cause the gain exclusion provision under Section 18152.5(a) to also be deemed unconstitutional. The court’s decision in *Cutler* also did not address whether the unconstitutional definitional language in Section 18152.5 (and the Section 18038.5(b)(1) cross-reference to that language), upon which the property and payroll requirement is based, could be excised from the statutes or whether the decision would operate to invalidate both statutes in their entirety.

Finally, as discussed above, the Court of Appeal declined to decide whether the taxpayer should be afforded the refund requested or whether some other appropriate remedy, if any, should apply and instead remanded the case to the trial court for further proceedings to address the remaining factual dispute and, if appropriate, the remedy.¹⁷

Considerations

Taxpayers denied benefit under either the *gain deferral* or *gain exclusion* statutes by application of the property and payroll requirement may wish to consider the filing of protective refund claims to preserve open tax years in the event any undecided issues, including those mentioned above, are favorably resolved.¹⁸ However, it is also conceivable that the FTB could issue assessments for all open years, even if the taxpayer in *Cutler* ultimately is granted a refund.

⁶ *Cutler*, slip op. at 13.

⁷ *Cutler*, slip op. at 6-7.

⁸ *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996).

⁹ *Ceridian Corp. v. Franchise Tax Bd.*, 85 Cal. App.4th 875 (Cal. Ct. App. 2000).

¹⁰ *Farmer Bros. Co. v. Franchise Tax Bd.* 108 Cal. App.4th 976 (Cal. Ct. App. 2003).

¹¹ *Cutler*, slip op. at 15.

¹² *Cutler*, slip op. at 12, 15, citing *Fulton Corp. v. Faulkner*, 516 U.S. at 333.

¹³ *Cutler*, slip op. at 15.

¹⁴ *Cutler*, slip op. at 17.

¹⁵ *Id.*

¹⁶ See note 4 *supra*.

¹⁷ *Cutler*, slip op. at 17.

¹⁸ The decision to file a refund claim should take into consideration all relevant facts and circumstances, including that such filing could trigger an overall income/franchise tax audit.

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