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# Chapter 546: Preventing Retroactive Taxes on Entrepreneurs

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## *Revenue and Tax*

### **Chapter 546: Preventing Retroactive Taxes on Entrepreneurs**

*Nicholas Kump*

#### *Code Sections Affected*

Revenue & Tax Code § 18153 (new and repealed), § 18038.5 (amended and repealed), § 18152.5 (amended and repealed)  
AB 1412 (Bocanegra); 2013 STAT. Ch. 546.

#### I. INTRODUCTION

New businesses and entrepreneurs create the vast majority of new jobs in California<sup>1</sup> and are a valuable commodity in a state like California that is struggling with a reputation of being “unfriendly” toward businesses.<sup>2</sup> So it came as a surprise when, just days before Christmas in 2012, thousands of small business owners received a notice of forthcoming tax assessments retroactively taxing them on the sale of their businesses.<sup>3</sup> A California appellate court declared that a tax exclusion that incentivized investment in California startups was unconstitutional.<sup>4</sup> The Franchise Tax Board implemented the court’s ruling by imposing retroactive taxes on all taxpayers who took the exclusion between 2008

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1. Ian Hathaway, *California Tax Change Will Hurt Entrepreneurs and Job Creation*, ENGINE BLOG (Apr. 8, 2013), <http://engine.is/blog/posts/california-tax-change-will-hurt-entrepreneurs-and-job-creation> (on file with the *McGeorge Law Review*) (stating that over the past three decades businesses less than one year old add an average of 398,193 new jobs each year, compared to companies older than one year that lose an average of 192,501 each year).

2. See Letter from Henry Perea, Assembly Member, Cal. State Assembly, et al. to Selvi Stanislaus, Executive Officer, Franchise Tax Board (Feb. 19, 2013) (noting that if California cannot provide certainty in its regulations, then businesses may be attracted to other states with more predictable regulations); see also Omar Akhtar, *The California Tax That Terrifies Tech*, FORTUNE MAGAZINE (Feb. 21, 2013), <http://tech.fortune.cnn.com/2013/02/21/the-california-tax-that-terrifies-tech/> (on file with the *McGeorge Law Review*) (“He says it’s unlikely he or fellow entrepreneurs will ever move back. ‘It’s just become a very unfriendly state to run a company,’ says Kinzell. ‘Once that sort of bleed starts, it gets hard to reverse it.’”) (quoting serial entrepreneur John Kinzell).

3. Notice from Franchise Tax Board Legal Division, FTB Notice 2012-03 (Dec. 21, 2012) [hereinafter Franchise Tax Board Notice] (on file with the *McGeorge Law Review*).

4. *Cutler v. Franchise Tax Bd.*, 208 Cal. App. 4th 1247, 1251, 1261, 146 Cal. Rptr. 3d 244, 245–46, 255 (2d Dist. 2012); Franchise Tax Board Notice, *supra* note 3. Although supporters of Chapter 546 contend that the *Cutler* decision only invalidated a portion of the QSBS exclusion. Letter from California Business Defense, to Edmund G. Brown Jr., Governor, State of California (Feb. 22, 2013) (on file with the *McGeorge Law Review*) (“The only issue before the court was the constitutionality of the so called ‘active business requirement’ of the statute.”).

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and 2012.<sup>5</sup> Suddenly facing up to hundreds of thousands of dollars in retroactive taxes and few alternatives, the affected taxpayers turned to the legislature to craft a suitable remedy.<sup>6</sup>

## II. LEGAL BACKGROUND

Section A summarizes the California qualified small business stock (QSBS) exclusion program as it existed between 1993–2012.<sup>7</sup> Section B examines the California appellate court decision that found the QSBS exclusion unconstitutional.<sup>8</sup> Lastly, Section C describes the basis for the Franchise Tax Board’s implementation of the appellate court’s decision.<sup>9</sup>

### A. California Qualified Small Business Stock Exclusion Pre-Cutler

Beginning in 1993, and up until the *Cutler* decision in 2012, the QSBS exclusion allowed individual taxpayers to exclude from gross income fifty percent of any gain on the sale of stock in certain small businesses.<sup>10</sup> Establishing the QSBS exclusion marked a significant victory for startup businesses and created an incentive to invest in California small businesses.<sup>11</sup> The California Revenue and Tax Code specified several business requirements in order for entities to be eligible for the exclusion.<sup>12</sup> Eligibility for the California QSBS exclusion was nearly identical to a federal QSBS exclusion under the Internal Revenue Code, which allows taxpayers to exclude fifty percent of the gain from the sale of qualified small business stock from gross income on federal taxes.<sup>13</sup>

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5. Franchise Tax Board Notice, *supra* note 3.

6. Christopher Cadelago, *Lawmakers Tackle Back Tax Grab*, SD UNION TRIBUNE (Mar. 6, 2013), <http://www.utsandiego.com/news/2013/mar/06/lawmakers-tackle-back-tax-grab/> (on file with the *McGeorge Law Review*).

7. *Infra* Part II.A.

8. *Infra* Part II.B.

9. *Infra* Part II.C.

10. CAL. REV. & TAX. CODE § 18152.5 (a), *declared unconstitutional by* *Cutler v. Franchise Tax Bd.*, 208 Cal. App. 4th 1247, 1261, 146 Cal. Rptr. 3d 244, 255 (2d Dist. 2012).

11. Letter from Selvi Stanislaus, Executive Officer, Franchise Tax Board, to Ted Lieu, Senator, Cal. State Senate (Feb. 5, 2013).

12. *See* REV. & TAX. § 18152.5 (d)(1)(A–D), *declared unconstitutional by* *Cutler v. Franchise Tax Bd.*, 208 Cal. App. 4th 1247, 1261, 146 Cal. Rptr. 3d 244, 255 (2d Dist. 2012) (stating that in addition to several other limitations and requirements to use the exclusion, the four requirements to be a “qualified small business” were 1) that the “aggregate gross assets” of the business did not exceed fifty million dollars at the time the stock was issued; and 2) any time after July 1, 1993; 3) that 80% of the payroll was for California employees; and 4) the business agreed to submit paperwork as required to the Franchise Tax Board).

13. *Compare* 26 U.S.C. § 1202 (2006), with CAL. REV. & TAX. CODE § 18152.5 (West 2004) *declared unconstitutional by* *Cutler v. Franchise Tax Bd.*, 208 Cal. App. 4th 1247, 1261, 146 Cal. Rptr. 3d 244, 255 (2d Dist. 2012).

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However, California's QSBS exclusion differed from the Internal Revenue Code because to qualify for the California exclusion, "at least 80 percent of the corporation's payroll, as measured by total dollar value, [must have been] attributable to employment located within California" at the date the stock was issued,<sup>14</sup> and for "substantially all of the taxpayer's holding period for the stock" the small business must have met the California-specific "active business requirements."<sup>15</sup> The California "active business requirements" mandated that eighty percent of assets had to be used for business in California,<sup>16</sup> and eighty percent of the payroll had to be used for California employees.<sup>17</sup>

Taxpayers could also opt to invest the gains from the sale of QSBS into another qualified small business.<sup>18</sup> If taxpayers did this within sixty days of the sale, the taxable gain was reduced by the amount invested in the new qualified small business.<sup>19</sup>

*B. The Cutler Decision*

In 2012, the California Second District Court of Appeals declared the California QSBS exclusion unconstitutional.<sup>20</sup> However, the only issue before the Court was the California-specific "active business requirements," not the requirement that eighty percent of payroll be attributable to California employment at the time the corporation issued the stock.<sup>21</sup> In the case, appellant Frank Cutler claimed the QSBS exclusion in 1998 after he sold his stock in a California Internet startup.<sup>22</sup> Yet, the Franchise Tax Board determined that the stock did not meet the requirements of Revenue and Tax Code Section 18152.5.<sup>23</sup> As a result, Cutler had to pay taxes on his full income without the QSBS exclusion.<sup>24</sup>

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14. REV. & TAX. § 18152.5 (c)(1)(A), (d)(1)(C) *declared unconstitutional by* Cutler v. Franchise Tax Bd., 208 Cal. App. 4th 1247, 1261, 146 Cal. Rptr. 3d 244, 255 (2d Dist. 2012).

15. *Id.* § 18152.5 (c)(2)(A).

16. *Id.* § 18152.5 (e)(1)(A).

17. *Id.* § 18152.5 (e)(9).

18. *Id.* § 18038.5 (a).

19. *Id.* § 18038.5 (a)(1), (b)(3).

20. Cutler v. Franchise Tax Bd., 208 Cal. App. 4th 1247, 1261, 146 Cal. Rptr. 3d 244, 255 (2d Dist. 2012) ("The statute is discriminatory on its face and cannot stand under the commerce clause.").

21. *See id.* at 1253, 1262, 146 Cal. Rptr. 3d at 248, 255 (referring to the "active business requirements" as the "California property and payroll requirement" and stating that was the issue before the court); *see also* Letter from California Business Defense, to Edmund G. Brown Jr., Governor, State of California, (Feb. 22, 2013) (on file with the *McGeorge Law Review*) ("The only issue before the court was the constitutionality of the so called 'active business requirement' of the statute.").

22. Cutler, 208 Cal. App. 4th at 1252, 146 Cal. Rptr. 3d at 247.

23. *Id.*

24. *Id.*

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In court, Cutler argued that the “active business requirements” violated the Commerce Clause of the US Constitution by discriminating against out-of-state businesses.<sup>25</sup> He argued that the proper remedy was not enforce the discriminatory “active business requirements,” which would allow him to qualify for the exclusion and entitle him to a refund.<sup>26</sup>

The appellate court agreed with Cutler that the “active business requirements” were facially discriminatory and held that the QSBS exclusion violated the Commerce Clause.<sup>27</sup> The court found that the QSBS exclusion violated the Commerce Clause because the California-specific “active business requirements,” “favor investment in corporations doing business within the State.”<sup>28</sup> However, because the only issue before the court was the California-specific “active business requirements,” the court did not address the requirement that eighty percent of the payroll be in California at the time the corporation issued the stock.<sup>29</sup> Moreover, the court did not attempt to sever the facially discriminatory “active business requirements” from the other requirement that the court did not address.<sup>30</sup>

### C. The Franchise Tax Board’s Implementation of the Cutler Decision

The Franchise Tax Board implemented the *Cutler* decision by denying the QSBS exclusion to all taxpayers who benefited from the exclusion after January 1, 2008.<sup>31</sup> The Franchise Tax Board sent notices to all taxpayers who took the exclusion and retroactively taxed them for the amount that they should have paid without the QSBS exclusion.<sup>32</sup> Only taxpayers who took the exclusion in 2008 received the notices because of a four-year statute of limitations.<sup>33</sup> Some taxpayers faced retroactive taxes in the six figures and estimates showed that the retroactive tax assessments would produce \$120 million dollars in revenue for California.<sup>34</sup>

The Franchise Tax Board was guided by two court decisions when it decided how to implement the *Cutler* decision: the US Supreme Court’s decision in

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25. *Id.*

26. *Id.*

27. *Id.* at 1261, 146 Cal. Rptr. 3d at 255.

28. *Id.* at 1259, 146 Cal. Rptr. 3d at 253 (citing *Fulton Corp. v. Faulkner* 516 U.S. 325, 343 (1996)).

29. *See id.* at 1253, 1262, 146 Cal. Rptr. 3d at 248, 255 (ruling only on the “active business requirements” portion of the statute); Letter from California Business Defense, to Edmund G. Brown Jr., Governor, State of California, (Feb. 22, 2013) (on file with the *McGeorge Law Review*) (“The only issue before the court was the constitutionality of the so called ‘active business requirement’ of the statute.”).

30. ASSEMBLY FLOOR, COMMITTEE ANALYSIS OF SB 209, at 6 (Sept. 11, 2013).

31. Franchise Tax Board Notice, *supra* note 3.

32. *See id.*

33. *Id.*

34. Akhtar, *supra* note 2.

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*McKesson Corp v. Florida Alcohol & Tobacco Division* and the California Fourth District Court of Appeal's decision in *River Garden Retirement Home v. Franchise Tax Board*.<sup>35</sup> In *McKesson*, the Supreme Court held that "meaningful backward-looking relief" is a valid remedy for an unlawful tax as long as the remedy places the individuals who received the benefit in the same position as the individual unlawfully taxed.<sup>36</sup> In *River Garden Retirement Home*, the court held that the Franchise Tax Board has the authority to fashion the remedy for an unconstitutional tax, and that the taxpayer is not automatically denied due process when the Franchise Tax Board imposes a retroactive tax.<sup>37</sup>

The Franchise Tax Board could have separated the unconstitutional "active business requirements" addressed in *Cutler*, leaving only the requirement that eighty percent of payroll be in California at the time the corporation issued the stock.<sup>38</sup> However, the Franchise Tax Board only considered the alternative of granting the QSBS exclusion to all taxpayers, and did not consider leaving the requirement that eighty percent of payroll be in California at the time the corporation issued the stock, which was not addressed in *Cutler*.<sup>39</sup> According to the Franchise Tax Board, there was not enough evidence to conclude that the legislature would have still adopted the statute if the statute granted the exclusion to taxpayers who sold stock in all qualified small businesses.<sup>40</sup> As a result, the Franchise Tax Board determined that its only option was to retroactively tax those who took the QSBS exclusion.<sup>41</sup>

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35. Franchise Tax Board Notice, *supra* note 3.

36. *McKesson Corp. v. Florida Alcohol & Tobacco Div.*, 496 U.S. 18, 40–41, (1990) (holding that a state's remedy includes three possibilities 1) refunding the taxpayer the difference between what the taxpayer paid and what others who received the benefit paid; 2) retroactively taxing the individuals who received the benefit; and 3) a combination of options 1) and 2)).

37. *River Garden Retirement Home v. Franchise Tax Bd.*, 186 Cal. App. 4th 922, 943, 113 Cal. Rptr. 3d 62, 76 (1st Dist. 2010) (stating the nature of the tax and circumstances in which it is imposed need to be considered on a case by case basis).

38. See CAL. REV. & TAX. CODE § 17033.

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 this part, nor, will the application of any such provision to other persons, taxpayers or circumstances, be affected thereby.

*Id.*

39. See Letter from Selvi Stanislaus, Executive Officer, Franchise Tax Board, to Henry Perea, Assembly Member, Cal. State Assembly (Feb. 25, 2013) [hereinafter Stanislaus Letter] (on file with the *McGeorge Law Review*) ("[T]he QSBS would need to be rewritten to exclude the 80% payroll and property requirements, thereby making the QSBS benefits available to all taxpayers for investments in all qualified small businesses regardless of location. Only in this way can those who have utilized the QSBS provisions keep those benefits while the discrimination is cured.").

40. *Id.*

41. *Id.*

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As an administrative agency, the options available to the Franchise Tax Board were limited by the California Constitution, but the Board noted that the legislature has broad authority to craft a different remedy that may be more beneficial for taxpayers.<sup>42</sup>

### III. CHAPTER 546

Chapter 546 eliminates the burden on taxpayers who took the QSBS exclusion between 2008 and 2012.<sup>43</sup> It allows fifty percent of the sale of the qualified small business stock to be excluded from an individual's gross income.<sup>44</sup> Chapter 546 removes the unconstitutional "active business requirements" from the QSBS exclusion.<sup>45</sup> This removal leaves only one California-specific requirement: when the stock is issued, "at least 80 percent of the corporation's payroll, as measured by total dollar value, [must be] attributable to employment located within California."<sup>46</sup> The other requirements to qualify for the QSBS exclusion between 2008 and 2012 remain unchanged.<sup>47</sup>

Chapter 546 allows taxpayers to exclude the entire gain from the sale of qualified small business stock if that gain is reinvested in a new qualified small business.<sup>48</sup>

If Chapter 546 is found unconstitutional and taxpayers are required to pay a retroactive tax, taxpayers are not required to pay the entire retroactive tax immediately and may establish a payment plan with the Franchise Tax Board.<sup>49</sup> Chapter 546 also prohibits the Franchise Tax Board from imposing penalties and interest on individuals affected by Chapter 546.<sup>50</sup> Additionally, only the portions of Chapter 546 that prohibit interest and penalties, and allow for the payment

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42. *Id.*

43. CAL. REV. & TAX. CODE § 18152.5 (a), (n) (enacted by Chapter 546) (allowing taxpayers to exclude fifty percent of the gain from the qualified small business stock sale from gross income instead of eliminating the exclusion altogether as the Franchise Tax Board did).

44. *Id.* § 18152.5 (a) (enacted by Chapter 546).

45. Compare REV. & TAX. § 18152.5 (enacted by Chapter 546) (removing the "active business requirements" from section 18152.5 (e)(1)(A) and (e)(9)), with CAL. REV. & TAX. CODE § 18152.5 (containing the active business requirements) *declared unconstitutional* by Cutler v. Franchise Tax Bd., 208 Cal. App. 4th 1247, 1261, 146 Cal. Rptr. 3d 244, 255 (2d Dist. 2012).

46. REV. & TAX. § 18152.5 (d)(1)(C) *declared unconstitutional* by Cutler v. Franchise Tax Bd., 208 Cal. App. 4th 1247, 1261, 146 Cal. Rptr. 3d 244, 255 (2d Dist. 2012).

47. Compare REV. & TAX. § 18152.5 (enacted by Chapter 546), with CAL. REV. & TAX. CODE § 18152.5 *declared unconstitutional* by Cutler v. Franchise Tax Bd., 208 Cal. App. 4th 1247, 1261, 146 Cal. Rptr. 3d 244, 255 (2d Dist. 2012).

48. CAL. REV. & TAX. CODE § 18038.5 (a) (enacted by Chapter 546). This provision is known as the deferral provision. FRANCHISE TAX BOARD, BILL ANALYSIS OF AB 1412, at 3 (Sept. 13, 2013).

49. CAL. REV. & TAX. CODE § 18038.5 (a)(3) (enacted by Chapter 546)

50. *Id.* 18153 (a)(1), (2) (enacted by Chapter 546).

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plan, are severable.<sup>51</sup> The other portions are not severable; if they are declared invalid, they will invalidate all other sections.<sup>52</sup> The legislature asserts that Chapter 546 and the amendments to the Tax Code strike a balance between protecting job creators in California and implementing a constitutional tax policy.<sup>53</sup>

The passage of the QSBS exclusion with the fifty percent exclusion and the deferral provision only apply to QSBS sales made prior to January 1, 2013.”<sup>54</sup> Chapter 546 also applies to QSBS sales that are only partially complete and being made in installment payments that go past 2013.<sup>55</sup> Chapter 546 is automatically repealed on January 1, 2016.<sup>56</sup>

## IV. ANALYSIS OF CHAPTER 546

Section A of this Part examines whether Chapter 546 achieves its goal of relieving the taxpayers who were adversely affected by the Franchise Tax Board’s implementation of the *Cutler* decision.<sup>57</sup> Section B analyzes whether the remaining payroll requirement in Chapter 546 is susceptible to the same constitutional challenge as the previous requirements of the QSBS exclusion.<sup>58</sup> Section C examines the fiscal implications of Chapter 546 for entrepreneurs in California, both in the long-term and immediately.<sup>59</sup>

A. *Does Chapter 546 Achieve Its Goal of Relieving the Affected Taxpayers?*

Following the Franchise Tax Board’s notice in December 2012, affected taxpayers suddenly faced substantial and unexpected tax assessments.<sup>60</sup> The Franchise Tax Board took the position that the appropriate remedy under the California Constitution was to issue the tax assessments.<sup>61</sup> For the individuals affected by the tax, this seemed fundamentally unfair.<sup>62</sup> Several individuals

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51. 2013 Cal. Stat. Ch. 546, § 6.

52. *Id.* § 6.

53. *Id.* § 4.

54. CAL. REV. & TAX. CODE §§ 18152.5 (m), 18038.5 (c) (enacted by Chapter 546).

55. *Id.* § 18152.5 (m) (enacted by Chapter 546).

56. *Id.* § 18152.5 (n) (enacted by Chapter 546).

57. *Infra* Part IV.A.

58. *Infra* Part IV.B.

59. *Infra* Part IV.C.

60. Akhtar, *supra* note 2.

61. FRANCHISE TAX BOARD, BILL ANALYSIS OF AB 1412, at 4 (Sept. 13, 2013).

62. Dan Walters, *Tax Break Flap Lands in California’s Capitol*, SACRAMENTO BEE (Apr. 29, 2013), [http://www.sacbee.com/2013/04/29/5378840/dan-walters-tax-break-flap-lands.html#mi\\_rss=Dan%20Walters?utm\\_source=feedly](http://www.sacbee.com/2013/04/29/5378840/dan-walters-tax-break-flap-lands.html#mi_rss=Dan%20Walters?utm_source=feedly) (on file with the *McGeorge Law Review*).



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formed a coalition called California Business Defense to overturn the Franchise Tax Board's decision.<sup>63</sup>

Chapter 546 is nearly identical to another law passed this session: Chapter 543.<sup>64</sup> The only difference between the laws is that Chapter 546 provides for the full fifty-percent exclusion instead of the thirty-eight percent proposed in Chapter 543.<sup>65</sup> Chapter 546 surfaced in the last few days of the legislative session as an alternative to the partial relief provided by Chapter 543.<sup>66</sup>

The bill carrying Chapter 543, SB 209, originally provided a fifty-percent exclusion just like Chapter 546.<sup>67</sup> The initial purpose of Chapter 543 was to assist the affected taxpayers by precluding the Franchise Tax Board from assessing the retroactive taxes in Notice 2012-3.<sup>68</sup> However, the Senate Appropriations Committee amended Chapter 543 to allow the Franchise Tax Board to assess the taxes, but permit the affected taxpayers to exclude thirty-eight percent of the gains from the sale of QSBS.<sup>69</sup>

Chapter 546 "chapters out"<sup>70</sup> Chapter 543, making Chapter 543 inoperative.<sup>71</sup> Although Chapter 543 has no legal effect, Chapter 546 ultimately accomplishes the original purpose of Chapter 543 because Chapter 546 totally relieves the affected taxpayers from 2008 to 2012—allowing them to claim the complete fifty-percent exclusion and preserving the deferral provision.<sup>72</sup>

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63. *About Us*, CALIFORNIA BUSINESS DEFENSE, [http://www.cabusinessdefense.org/?page\\_id=5](http://www.cabusinessdefense.org/?page_id=5) (last visited on June 8, 2013) (on file with the *McGeorge Law Review*).

64. *Compare* 2013 Stat. Ch. 543 with 2013 Stat. Ch. 546.

65. *Id.*

66. Brian Overstreet, *How We Overturned the Retroactive Tax on Startup Founders*, XCONOMY (Oct. 7, 2013), <http://www.xconomy.com/boston/2013/10/07/overturned-retroactive-tax-startup-founders/> (on file with the *McGeorge Law Review*).

67. SENATE GOVERNANCE AND FINANCE COMMITTEE, COMMITTEE ANALYSIS OF SB 209, at 3 (April 3, 2013).

68. See CASenDems, *Lawmakers & Small Business Owners Call for Action on State's Retroactive Tax*, (April 30, 2013), [http://www.youtube.com/watch?feature=player\\_embedded&v=T\\_LqrQSx2f0](http://www.youtube.com/watch?feature=player_embedded&v=T_LqrQSx2f0) ("We have introduced SB 209, that will reverse that [retroactive taxes from 2008-2012] it will hold those taxpayers harmless that relied on the qualified small business tax statute.") (0:48–0:57).

69. SENATE APPROPRIATIONS COMMITTEE, COMMITTEE ANALYSIS OF SB 209, at 2 (May 23, 2013).

70. Chaptering out occurs "[w]hen, during a calendar year, two or more bills amending the same code section become law, the bill enacted last (with a higher chapter number) becomes law and prevails over ('chapters out') the code section in the bill or bills previously enacted." *Glossary of Legislative Terms*, <http://www.legislature.ca.gov/quicklinks/glossary.html> (last visited Oct. 30, 2013).

71. Press Release, Office of Governor Edmund G. Brown, Governor Brown Signs Legislation to Support California Businesses (Oct. 4, 2013), <http://gov.ca.gov/news.php?id=18251> (on file with the *McGeorge Law Review*).

72. SENATE FLOOR, COMMITTEE ANALYSIS OF AB 1412, at 1, 3 (Sept. 11, 2013).

*B. Are the Changes to the Qualified Small Business Stock Exclusion Constitutional?*

Chapter 546 reenacts a modified version of California's QSBS exclusion.<sup>73</sup> Chapter 546 eliminates the unconstitutional portions specifically addressed in *Cutler*, leaving only the requirement that eighty percent of the payroll dollar value be for California employment at the time the corporation issues the stock.<sup>74</sup> The constitutionality of this requirement remains unsettled and subject to a dormant Commerce Clause challenge.<sup>75</sup>

The Franchise Tax Board did not analyze the constitutionality of the requirement that eighty percent of payroll be for employment in California at the time the corporation issued the stock because it did not think it had the power to unilaterally sever this portion of the statute.<sup>76</sup> Requiring eighty percent of payroll in California when the corporation issues the stock draws a distinction between in-state and out-of-state businesses, but the distinction does not automatically invalidate the incentive.<sup>77</sup> The crucial inquiry in the commerce clause analysis is whether the benefit allows the taxpayer to avoid a tax liability altogether or reduces a pre-existing burden, making it coercive in nature.<sup>78</sup> Chapter 546 only looks at the moment when the stock is issued and does not require continuous investment in California to the exclusion of other states.<sup>79</sup>

The court stated in *Cutler* that a tax structure that varies depending on the level of participation in interstate commerce unduly restricts domestic businesses from participating in interstate commerce.<sup>80</sup> Chapter 546 only requires that eighty percent of payroll be for California employment when the corporation issues the stock, which a court may find distinct from the requirement in *Cutler*.<sup>81</sup>

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73. ASSEMBLY FLOOR, COMMITTEE ANALYSIS OF AB 1412, at 1–2 (Sept. 11, 2013).

74. *Id.*

75. See ASSEMBLY FLOOR, COMMITTEE ANALYSIS OF SB 209, at 6–7 (Sept. 11, 2013) (noting that the *Cutler* court did not consider whether the unconstitutional portions could be severed and the Franchise Tax Board refused to do so).

76. Stanislaus Letter, *supra* note 39 (“[T]his exhaustive review found no option available to the FTB but to acknowledge the determination of the court that the provisions are unenforceable as written and to assess and collect additional tax for tax years within the statute of limitations.”).

77. Walter Hellerstein & Dan Coesnen, *Commerce Clause Restraints on State Business Development Incentives*, 81 CORNELL L. REV. 789, 802 (1996) (noting that almost every state income tax in the country draws a geographic distinction, but do not violate the Commerce Clause).

78. *Cuno v. Daimler Chrysler, Inc.*, 386 F.3d 738, 747 (6th Cir. 2004) (holding that a statute granting a tax exclusion to companies that established facilities and hired employees in poor communities did not violate the commerce clause).

79. ASSEMBLY FLOOR, COMMITTEE ANALYSIS OF AB 1412, at 1–2 (Sept. 11, 2013).

80. *Cutler v. Franchise Tax Bd.*, 208 Cal. App. 4th 1247, 1259, 146 Cal. Rptr. 3d 244, 253 (2d Dist. 2012) (citing *Fulton Corp. v. Faulkner* 516 U.S. 325, 333 (1996)).

81. Robert Waldow & Roy Crawford, *How Should California Policymakers Respond to Cutler?*, STATE TAX NOTES, Apr. 1, 2013.

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However, this argument is still speculative, and because the constitutionality of Chapter 546 remains unclear, additional litigation may follow to decisively settle this issue.<sup>82</sup>

The legislature ensured that there will not be any questions regarding the Franchise Tax Board's ability to preserve any portion of Chapter 546 if any other portion of Chapter 546 other than Section 3 is found to be unconstitutional.<sup>83</sup> This ensures taxpayers remain protected from interest and penalties because Section 3, which is the section prohibiting the imposition of interest and penalties, is the only severable portion of Chapter 546.<sup>84</sup>

Opponents of Chapter 546 are concerned about both the potential legal costs of defending Chapter 546 and the precedent it will set for future tax lawsuits.<sup>85</sup> With *Cutler* establishing the unconstitutionality of discriminatory tax benefits, other out-of-state individuals denied tax breaks may challenge these tax benefits as well.<sup>86</sup> Moreover, with Chapter 546 fashioning a legislative solution for affected taxpayers, opponents are concerned that future similarly-situated taxpayers may seek legislative fixes as well.<sup>87</sup>

### C. Fiscal Impact of Chapter 546

The fiscal impact of Chapter 546 is uncertain.<sup>88</sup> With a baseline assuming that the state will collect retroactive taxes on all taxpayers that took the QSBS exclusion between 2008–2011, the Franchise Tax Board estimates that restoring

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82. ASSEMBLY APPROPRIATIONS COMMITTEE, COMMITTEE ANALYSIS OF SB 209, at 5 (Aug. 20, 2013). This statement regarding constitutionality of Chapter 543 also applies to Chapter 546 because Chapter 543 and 546 are identical except for the change in percentage of the sale of the qualified small business stock that can be excluded from an individual's gross income. *Compare* 2013 Stat. Ch. 543, *with* 2013 Stat. Ch. 546.

83. ASSEMBLY APPROPRIATIONS COMMITTEE, COMMITTEE ANALYSIS OF SB 209, at 6–7 (Aug. 20, 2013) (stating that making the portions of Chapter 543 non-severable keeps the policy-making responsibility with the legislature and prevents the Franchise Tax Board or courts from attempting to sever portions of Chapter 543). This statement justifying severability also applies to Chapter 546 because Section 6 of Chapters 543 and 546 are identical. *Compare* 2013 Stat. Ch. 543 § 6, *with* 2013 Stat. Ch. 546 § 6.

84. 2013 Cal. Stat. Ch. 546, § 6. The provision ensuring protection from paying interest is likely unnecessary though as the Franchise Tax Board is prohibited from collecting interest on an unpaid tax. *Fischbach & Moore, Inc v. State Bd. of Equalization*, 117 Cal. App. 3d 627, 633, 172 Cal. Rptr. 923, 927 (Ct. App. 1981) (holding that collecting interest was “unjustifiable and inequitable” when taxpayers justifiably relied on the Board of Equalization).

85. ASSEMBLY APPROPRIATIONS COMMITTEE, COMMITTEE ANALYSIS OF SB 209, at 5 (Aug. 20, 2013). This statement regarding the precedent set by Chapter 543 also applies to Chapter 546 because Chapter 543 and 546 are identical except for the change in percentage of the sale of the qualified small business stock that can be excluded from an individual's gross income. *Compare* 2013 Stat. Ch. 543, *with* 2013 Stat. Ch. 546.

86. ASSEMBLY APPROPRIATIONS COMMITTEE, COMMITTEE ANALYSIS OF SB 209, at 5 (Aug. 20, 2013).

87. *See id.* This statement regarding future legal challenges to tax benefits such as Chapter 543 also applies to Chapter 546 because Chapter 543 and 546 are identical except for the change in percentage of the sale of the qualified small business stock that can be excluded from an individual's gross income. *Compare* 2013 Stat. Ch. 543, *with* 2013 Stat. Ch. 546.

88. ASSEMBLY FLOOR, COMMITTEE ANALYSIS OF AB 1412, at 1–2 (Sept. 11, 2013).

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the QSBS exclusion results in a \$131.8 million net loss for the State.<sup>89</sup> The Franchise Tax Board attributes this loss primarily to the state not collecting retroactive taxes and new individuals that are now eligible for the QSBS exclusion under Chapter 546 collecting a refund.<sup>90</sup> Additional revenue losses in the “tens of millions” of dollars are possible if the State is forced to defend the constitutionality of Chapter 546 in subsequent litigation.<sup>91</sup>

On the other hand, in estimating lost revenue, supporters of Chapter 546 start with a baseline that the QSBS exclusion was only partially eliminated by *Cutler*.<sup>92</sup> Under this interpretation, the losses to the general fund incurred by expanding the number of individuals who can take the QSBS exclusion are completely offset by the elimination of the QSBS exclusion in 2013.<sup>93</sup> Since Chapter 546 eliminates the QSBS exclusion in 2013, the State receives an additional \$20–30 million each year from not allowing the exclusion; this \$20–30 million annually into perpetuity offsets the loss to the general fund from expanding the number of individuals who can take the QSBS exclusion between 2008–2012.<sup>94</sup>

While the direct losses to the general fund depend on the baseline revenue used, a larger concern is that because Chapter 546 is automatically repealed in 2016 and eliminates the QSBS exclusion starting in 2013,<sup>95</sup> there is less incentive to invest in California startups in the future.<sup>96</sup> One study estimates that the elimination of the QSBS exclusion will cost California “between \$853 million and \$1.27 billion” in capital for startup ventures over the next ten years.<sup>97</sup> The

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89. FRANCHISE TAX BOARD, BILL ANALYSIS OF AB 1412, at 6 (Sept. 13, 2013).

90. The revenue loss also includes loss of interest and loss on installment payments. *Id.*

91. See ASSEMBLY APPROPRIATIONS COMMITTEE, COMMITTEE ANALYSIS OF SB 209, at 3 (Aug. 20, 2013) (stating that the state may have to defend the changes in litigation in reference to SB 209).

92. *Id.* at 4–5. This statement regarding baseline fiscal perspective of Chapter 543 also applies to Chapter 546 because Chapter 543 and 546 are identical except for the change in percentage of the sale of the qualified small business stock that can be excluded from an individual’s gross income. Compare 2013 Stat. Ch. 543, with 2013 Stat. Ch. 546.

93. See SENATE APPROPRIATIONS COMMITTEE, COMMITTEE ANALYSIS OF SB 209, at 1 (May 13, 2013) (stating that revenue losses would be made up during a dark period between 2013 and 2015 when the QSBS exclusion was eliminated). Chapter 546 does not include a dark period and eliminates the QSBS exclusion completely in 2013, so from this baseline point the annual future revenues from having no QSBS exclusion make up for the expansion of the QSBS from 2008 to 2012. See CAL. REV. & TAX. CODE § 18152.5 (m) (enacted by Chapter 546) (stating that the legislation only applies to sales prior to 2013 and not mentioning a dark period thus eliminating the QSBS exclusion entirely beyond 2013).

94. See Letter from Gail Hall, Director, Franchise Tax Board Legislative Services Bureau, to Ted Lieu, Senator, Cal. State Senate (July 11, 2013) (showing \$20–32 million annually in new revenue after the *Cutler* decision).

95. CAL. REV. & TAX. CODE § 18152.5 (m), (n) (enacted by Chapter 546).

96. Hathaway, *supra* note 1.

97. *Id.*

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ultimate cost is difficult to predict, but affected taxpayers remain concerned about their ability to build successful businesses moving forward.<sup>98</sup>

When the legislature extended the original legislation enacting the California QSBS exclusion in 1999, the Legislative Analyst's Office examined how effective the QSBS exclusion was at generating revenue for startups and creating jobs.<sup>99</sup> Although this analysis is over a decade old, the Legislative Analyst's Office could not quantify the benefits and questioned "why owners of small *corporate* enterprises should receive more favorable treatment than other types of small businesses."<sup>100</sup>

Despite the Legislative Analyst's Office's indecisive characterization of the California QSBS exclusion, the legislature extended the QSBS exclusion to assist California small businesses in generating additional capital.<sup>101</sup> Supporters of Chapter 546 contend that this purpose can still be fulfilled with a QSBS exclusion that only requires eighty percent of payroll in California when the stock is issued.<sup>102</sup> Congress enacted the federal QSBS exclusion for the similar purpose of incentivizing investment in small businesses.<sup>103</sup> Congress extended the federal QSBS exclusion in 2013 with an increase from fifty percent to one hundred percent of the gain from the sale of qualified small business stock allowed to be excluded.<sup>104</sup> With similar reasoning behind the exclusions, entrepreneurs who took the California QSBS exclusion question the wisdom of including the sunset clause.<sup>105</sup>

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98. Press Release, California Business Defense, Study Finds News Tax Policy Will Hurt California Entrepreneurs and Job Creation (Apr. 10, 2013) (on file with *McGeorge Law Review*).

99. ASSEMBLY FLOOR, COMMITTEE ANALYSIS OF SB 209, at 5 (Sept. 4, 2013). This statement of the benefit of the QSBS exclusion is relevant to Chapter 546 because Chapter 543 and 546 are identical except for the change in percentage of the sale of the qualified small business stock that can be excluded from an individual's gross income. Compare 2013 Stat. Ch. 543 with 2013 Stat. Ch. 546.

100. *Id.* (quoting the Legislative Analyst's Office report) (emphasis added).

101. ASSEMBLY FLOOR, COMMITTEE ANALYSIS OF AB 1120, at 2 (June 16, 1999).

102. ASSEMBLY FLOOR, COMMITTEE ANALYSIS OF SB 209, at 7 (Sept. 11, 2013). This assertion is relevant to Chapter 546 because Chapter 543 and 546 are identical except for the change in percentage of the sale of the qualified small business stock that can be excluded from an individual's gross income. Compare 2013 Stat. Ch. 543, with 2013 Stat. Ch. 546.

103. ASSEMBLY FLOOR, COMMITTEE ANALYSIS OF AB 1120, at 2 (June 16, 1999).

104. Christopher Cawley & Nicole Lemay, *Congress Extends the 100% Tax Exemption for Gain on Certain Qualified Small Business Stock, With Retroactive Effect, Through 2013*, JD SUPRA (Jan. 16, 2013), <http://www.jdsupra.com/legalnews/congress-extends-the-100-tax-exemption-38931/> (on file with the *McGeorge Law Review*).

105. See Press Release, California Business Defense, Study Finds News Tax Policy Will Hurt California Entrepreneurs and Job Creation (on file with *McGeorge Law Review*) (noting the value of capital for small businesses and the impact that eliminating the QSBS exclusion will have on available capital).

## V. CONCLUSION

Chapter 546 provides relief for entrepreneurs in the short-term, but leaves questions about California's concern for small business owners in the long-term because of the elimination of the QSBS exclusion beyond January 1, 2013.<sup>106</sup> California has much at stake as other states compete for California's innovative entrepreneurs with better tax incentives.<sup>107</sup> However, elected officials sent a strong message with Chapter 546 that small business owners can rely on California's leaders to maintain a predictable environment to build a business.<sup>108</sup> And, perhaps even more importantly, that Chapter 546 stands for the important concept that even in California's complicated political environment, an inexperienced, but motivated group of individuals that sees a problem can still find assistance and consideration in the legislature.<sup>109</sup>

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106. See Hathaway, *supra* note 1 (noting that California's economy is "vulnerable" and eliminating the QSBS exclusion "puts California's entrepreneurs at a relative disadvantage to those in other states").

107. Akhtar, *supra* note 2 (quoting Texas Governor Rick Perry and his statements about the difficulty of building a business in California).

108. Jeremy Merz, *Governor Signs Tax Bill Creating Dependable Tax Environment*, CAL CHAMBER (Oct. 9, 2013), <http://www.calchamber.com/headlines/pages/10092013-governorsignstaxbillcreatingdependabletaxenvironment.aspx> (on file with the *McGeorge Law Review*).

109. Brian Overstreet, *How We Overturned the Retroactive Tax on Startup Founders*, XCONOMY (Oct. 7, 2013), <http://www.xconomy.com/boston/2013/10/07/overturned-retroactive-tax-startup-founders/> (on file with the *McGeorge Law Review*).