PILLSBURY MADISON & SUTRO LLP
STATE & LOCAL TAX BULLETIN
MARCH 1996 CALIFORNIA TAX ALERT

Impending March 15, 1996 Deadline for Calendar Year Issuers of California Qualified Small Business Stock

In 1993 California's personal income tax law was amended to allow individuals to exclude from income 50 percent of the gain arising from dispositions of "qualified small business stock." *Cal.Rev.& Tax.Code § 18152.5.* This provision has a federal income tax counterpart, Internal Revenue Code section 1202 (also enacted in 1993), but contains some additional requirements noted below. The California and federal exclusions apply only to stock issued after August 10, 1993 and held for more than five years at the time of disposition. Thus, the earliest either exclusion could become relevant is 1998.

Nevertheless, the California Franchise Tax Board (the "FTB") recently announced that holders of qualified small business stock will no longer be eligible for the California 50 percent exclusion if the corporation issuing the stock fails to file a timely FTB Form 3565, Small Business Stock Questionnaire, with respect to the corporation's 1995 income year. For calendar year corporations the deadline for filing the FTB Form 3565 is Friday, March 15, 1996, a deadline the FTB has stated cannot be extended. For fiscal year corporations the deadline is the fifteenth day of the third month following the close of the corporation's fiscal year (*e.g.,* June 15, 1996 for a fiscal year ending March 31, 1996).

The FTB has provided taxpayers virtually no advance notice of this filing requirement. There is no comparable federal requirement and no mention of FTB Form 3565 in any California regulations. The form and its instructions are included in the FTB Form 100 (California Corporation Franchise or Income Tax Return) Booklet, also part of California's Package X, and the filing requirement is mentioned in the FTB's January 1996 "Tax News" Bulletin. The FTB claims denial of eligibility for the 50 percent exclusion is necessary to insure timely filing of the FTB Forms 3565 so that the FTB can fulfill its obligation to inform the legislature of the effectiveness of California tax incentives. *See 1993 Stats, Chap. 881, § 29 (S.B. 671).*

Any corporation that has issued qualified small business stock should file FTB Form 3565 by the applicable deadline (*e.g.,* March 15, 1996 for calendar year corporations) to permit the continued availability of the 50 percent California exclusion for the corporation's shareholders. Shareholders holding stock eligible for the California qualified small business stock exclusion may wish to contact the corporate issuers to satisfy themselves that the form has or will be timely filed. FTB Form 3565 is not to be filed with the California Franchise Tax Return (FTB Form 100), and is to be sent to a separate FTB address, Franchise Tax Board, P.O. Box 942857, Sacramento, CA 94257-0500.

Qualified Small Business Stock

Both the federal and California exclusions apply only to gain from the disposition of qualified small business stock held for more than five years. In general, 50 percent of the gain is excluded from income, subject to a limit for any taxable year equal to the greater of:

> $10 million reduced by gain excluded in prior taxable years with respect to stock of the same corporation, and
>
> 10 times the taxpayer's basis in qualified small business stock issued by the same corporation and disposed of by the taxpayer during the taxable year.

Qualified small business stock must be issued after August 10, 1993 and must be acquired by the taxpayer upon original issuance in exchange for money or other property (not including stock) or as compensation for services. The stock must be issued by a domestic C corporation (*i.e.,* it cannot be issued by an S corporation) the gross assets of which did not exceed $50 million (i) at all times on or after July 1, 1993 (on or after August 10, 1993 for the federal exclusion) and immediately prior to issuance of the stock and (ii) immediately after issuance of the stock taking into account amounts received upon the stock's issuance.

For further information please contact Jeffrey M. Vesely (jmv@pmstax.com), Richard E. Nielsen (ren@pmstax.com) or Craig A. Becker (cab@pmstax.com). This California tax alert is part of the Pillsbury Madison & Sutro LLP Tax Page at http://www.pmstax.com/state/alert9603.html. A link to ***FTB Form 3565*** *(in Adobe pdf format) can also be found at that location; alternatively, a pdf version of* ***FTB Form 3565*** *is available via ftp at ftp.pmstax.com/state/ftb3565.pdf.*

- The California exclusion additionally requires at least 80 percent of the issuing corporation's payroll to be attributable to employment located in California at the time of the stock's issuance.

Further, stock in a corporation will not constitute qualified small business stock unless throughout substantially all of the taxpayer's holding period for the stock the corporation remains a C corporation and at least 80 percent (by value) of the corporation's assets are used in the active conduct of one or more qualified trades or businesses.

- The California exclusion requires the active business or businesses to be conducted within California and considers the corporation to fail to meet the active business test for any period during which more than 20 percent of its payroll is attributable to employment located outside California.

The following do not constitute qualified trades or businesses:

Service businesses in the fields of, among others, health, law, engineering, architecture, accounting, performing arts, athletics, and financial or brokerage services,

Any banking, insurance, financing, leasing, investing or similar business,

Farming,

Any business involving the production or extraction of products of a character for which depletion is available and

Any business of operating a hotel, motel, restaurant or similar business.

Numerous special rules apply regarding such matters as start-up companies and operations (including research and development), a limitation on permitted real estate holdings, tax-free and other transfers of stock, stock redemptions and stock held by partnerships, S corporations and other "pass-through" entities.

It is not completely clear that the FTB has the authority to deny the California 50 percent exclusion on the sole ground that FTB Form 3565 was not timely filed. While both the federal and California statutes permit the IRS and FTB, respectively, to require the filing of information returns (I.R.C. § 1202(d)(1)(C); Cal.Rev.& Tax.Code § 18152.5(d)(1)(D)), the only explicit statutory penalty for failing to file those returns is $50, not denial of the shareholder's eligibility for the 50 percent exclusion (I.R.C. § 6652(k); Cal.Rev& Tax.Code § 19133.5). The FTB contends that the $50 penalty is directed only to the stock's corporate issuer and that the corporation's failure to file a timely information return causes the shareholder to fail to meet statutory prerequisites for the exclusion.