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*California FTB intends to deny previously allowed qualified small business stock gains and deferrals for 2008 and later years in response to Cutler*

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## ***In brief***

In August 2012, a California Court of Appeal in *Cutler v. Franchise Tax Board* ruled that the state's limitation of qualified small business stock (QSBS) gain deferral to in-state businesses was unconstitutional. Please [click here](#) for our summary of the *Cutler* decision.

The California Franchise Tax Board (FTB) recently issued guidance for how it intends to implement the *Cutler* decision, which includes completely denying taxpayers the QSBS exclusion and deferral for 2008 and later tax years. For tax years prior to 2008, the FTB will allow the exclusion/deferral to taxpayers that meet all QSBS qualifications other than the unconstitutional in-state requirements. [[FTB Notice 2012-03](#) (12/21/12)]

## ***In detail***

California provides a gain deferral relating to qualified small business stock similar to that found in I.R.C. sec. 1045, except that the deferral is limited to gains relating to small businesses based in California. In *Cutler*, the court ruled that limiting the gain deferral to in-state businesses is "facially unconstitutional." However, the court did not address the issue of remedy for impacted taxpayers.



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In FTB Notice 2012-03, the FTB interpreted *Cutler* to hold that California's QSBS exclusion and deferral provisions were unconstitutional, invalid, and unenforceable. The FTB provides that the appropriate remedy is to deny the exclusion/deferral to taxpayers that benefited from either the exclusion or deferral. The FTB's remedy differs depending on whether the tax year is generally open or closed under statute.

*Tax years beginning before January 1, 2008 - Exclusion/Deferral allowed*

Under the Notice, the FTB states that it cannot deny the exclusion/deferral to taxpayers in otherwise closed tax years because it must treat similarly situated taxpayers the same. Since other similarly situated taxpayers have benefited from the exclusion/deferral, and the FTB cannot issue assessments against such taxpayers, it must allow the exclusion/deferral to taxpayers that meet the qualified small business stock exclusion/deferral requirements other than the unconstitutional in-state requirements.

As a result, if a pre-2008 tax year is open for a taxpayer, the taxpayer may file a claim, or protective claim, for refund of tax attributable to an exclusion or deferral of QSBS gain. If a pre-2008 tax year is open due to an audit, protest, or claim in which the QSBS exclusion/deferral is at issue, the FTB will apply the exclusion/deferral consistent with FTB Notice 2012-03 as appropriate for each individual case.

*Tax years beginning on or after January 1, 2008 - Exclusion/Deferral denied*

The FTB will issue Notices of Proposed Assessments denying a QSBS exclusion or deferral to taxpayers that reported such exclusion or deferral for tax years beginning on or after January 1, 2008.

*Frequently asked questions*

As provided in FTB Notice 2012-03, the FTB has provided a [frequently asked questions page](#) on its website with additional guidance, including:

- Generally, there will not be penalties assessed due to the correction of a reported gain exclusion or deferral relating to QSBS.
- Interest will generally accrue. However, interest suspension is possible in certain circumstances.
- The penalty for underpayment of 2012 estimated tax could apply if an underpayment results from a taxpayer including the QSBS exclusion/deferral in its 2012 calculations.
- The impact on LLC fees and penalties to the extent an LLC has higher total income due to the elimination of QSBS benefits.

*The takeaway*

To the extent a federal QSBS capital gain exclusion/deferral was claimed by taxpayers in 2007 and prior tax years, a California gain exclusion/deferral benefit may now be claimed if it was not previously requested for taxpayers with open California statuses in 2007 and prior tax years. Taxpayers should claim these benefits as soon as possible before any open California statutes of limitations expire.

However, for all taxable years after 2007, any California capital gain exclusion/deferral benefits claimed under the QSBS rules are no longer available, and

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taxpayers should be aware that the FTB will be denying the QSBS benefits (i.e., deferral or exclusion) claimed, and will be issuing Notices of Proposed Assessment.

***Let's talk***

If you have questions about FTB Notice 2012-03, please contact any of the following individuals:

Sam Melehani  
Partner  
(213) 356-6900  
[sam.melehani@us.pwc.com](mailto:sam.melehani@us.pwc.com)

Brian Rebhun  
Principal  
(646) 471-4024  
[brian.rebhun@us.pwc.com](mailto:brian.rebhun@us.pwc.com)

Alan Bollinger  
Director  
(916) 930-8203  
[alan.d.bollinger@us.pwc.com](mailto:alan.d.bollinger@us.pwc.com)

Eran Liron  
Director  
(408) 817-3937  
[eran.j.liron@us.pwc.com](mailto:eran.j.liron@us.pwc.com)

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