

Qualified Small Business Stock: Beware State Conformity (Part II)

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This is Part II of a three-part article. Part I was published in the November 2005 issue of the M&A TAX REPORT.

California Definitions

Part I of this article compared the federal and California requirements for QSBS, highlighting their similarities as well as their differences. California enacted its own version of Internal Revenue Code Section (“Code Sec.”) 1202, California Rev. and Tax. Code Section (“CR&TC §”) 18152.5, rather than adopting the federal law. For California tax purposes, the definition of QSBS includes any domestic corporation that is a C corporation if (in addition to other statutory requirements discussed previously) at least 80 percent (by value) of the assets of the corporation are used by the corporation in the active conduct of one or more qualified trades or business in California, and at least 80 percent of the corporation’s payroll (as measured by the total dollar value) is attributable to employment in California. [CR&TC §18152.5(d)(1).]

A QSBS must employ at least 80 percent of the corporation’s assets and payroll in one or more trades or businesses in California during substantially all of the taxpayer’s holding period for the stock. The California tax law requires the corporation to meet an active business requirement during substantially all of the taxpayer’s five-year holding period for the stock. The active business requirement is satisfied if the corporation employs or uses 80 percent of its assets, and 80 percent of its payroll, in California during substantially all of the taxpayer’s five-year holding period for the stock.

Thus, a practitioner must resolve three issues to satisfy the active business requirement:

1. Did the QSBS use 80 percent of its assets in California during substantially all of the taxpayer’s five-year holding period for the stock?
2. Did the QSBS employ 80 percent of its payroll in California during substantially

all of the taxpayer’s five-year holding period for the stock?

3. What is the definition of “substantially all” for purposes of Code Sec. 1202 and CR&TC §18152.5?

The term “period” for purposes of the QSBS statute is undefined other than “the taxpayer’s holding period for the stock,” which is the five-year holding period for qualifying as a qualified small business. CR&TC §18152.5(c)(2)(A) specifically provides that the corporation must meet the active business requirement *during substantially all of the taxpayer’s holding period for the stock.*

Taking Stock

In a California audit, a Franchise Tax Board (“FTB”) auditor generally will attempt to define the term “assets” to mean “property” as the term is used for purposes of the California state franchise tax property factor. The property factor is used as part of the state franchise tax apportionment formula for apportioning a corporation’s income to California where the corporation does business both inside and outside California.

California defines “property” to mean only the real property and tangible personal property of the corporation. [CR&TC §25129.] This is a very narrow definition of property and certainly is not the definition of “assets” for QSBS purposes. It omits from its definition all current assets as well as all intangible assets of the corporation.

Under both federal and California law, “aggregate gross assets” means the sum of cash and the adjusted basis of other property held by the corporation. [Code Sec. 1202(d)(2)(A).] For this purpose, the adjusted basis of any property contributed to the corporation, and of any property whose basis is determined in whole or in part by reference to the adjusted basis of property so contributed, is determined by treating the basis of the contributed property immediately after the contribution as equal to its fair market value at that time. Code Sec. 1202(d)(2)(B), and CR&TC

§18152.5(d)(1)(A). However, this definition is broad and encompasses all assets including cash and cash equivalents.

Moreover, California defines “assets” (for purposes of the 80 percent asset test of §18152.5(e)(1)(A)) to include expenditures for start-up activities and for research as assets used in the conduct of a trade or business. Code Sec. 1202(e) and CR&TC §18152.5(e)(2). Assets held for the working capital needs of the business are also deemed to be used in the active conduct of a trade or business for QSBS purposes. [Code Sec. 1202(e)(6)(A) and CR&TC §18152.5(e)(6)(A).] This would include assets that are reasonably expected to be used within two years to finance research or increased needs for working capital.

Thus, for purposes of Code Sec. 1202 and CR&TC §18152.5, “assets” are defined as the sum of cash (and cash equivalents) and the adjusted basis of other property held by the corporation, working capital and expenditures for start-up activities and research. California’s tax law conforms to Code Sec. 1202 for QSBS subject to modifications. However, the California legislature did not alter the definition of assets under CR&TC §18152.5. Since the legislature defines “assets” broadly to include all assets for purposes of CR&TC §18152.5, the use of the term “property” by the FTB is completely inconsistent with both the statute on its face and with California law.

Since all QSBS corporations are headquartered in California, most current assets and intangible assets would be deemed to be located at the California headquarters of the company.

Not the Wages of Sin

The active business requirement is satisfied in California if the corporation employs or uses 80 percent of its assets, and 80 percent of its payroll, in California during substantially all of the taxpayer’s five-year holding period for the stock. This requirement does not exist in the federal QSBS statute. [Code Sec. 1202.]

The FTB auditor will want to use the franchise tax apportionment payroll factor to show the percentage of total payroll expense in California for QSBS purposes. As reflected on the California Schedule 100R, the payroll factor includes a numerator that is the total

amount an employer pays in California during a tax year as compensation, and a denominator that is the total compensation paid everywhere for the same tax year. [CR&TC §25132; Cal. Code Regs. 18 §25132(b) and 25132(c).

“Compensation” means wages, salaries, commissions and any other form of remuneration paid directly to employees for personal services connected with company’s business income. [CR&TC §25120(c); Cal. Code Regs. 18 §25132(a)(3).] However, CR&TC §18152.5 does not use the concept of compensation paid in determining total payroll expense. The statute also does not refer to the Schedule 100R or the payroll apportionment factor in defining total payroll expense.

Payroll expense clearly includes employer taxes, perquisites, and administrative costs. “Total payroll expense” as used in CR&TC §18152.5 is not equivalent to the “compensation paid.” The term “total payroll expense” is commonly defined as “compensation earned by employees, irrespective of when paid, including salaries, wages, commissions, bonuses, and other compensation, by an individual who during any years performs work or renders services, in whole or in part ...” (The term “total payroll expense” is also defined for Generally Accepted Accounting Procedures more broadly than payroll for purposes of the Form 100R. However, the FTB has refused to consider this definition.)

This is the commonly accepted definition of payroll expense used for payroll tax purposes in California and other states. The definition of total payroll expense is used determining a taxpayer’s payroll within (and outside) the taxing jurisdiction. Thus, the standard definition is consistent with the legislation’s purpose in using the term. There is no need to add an extraneous definition or requirement to the statute derived from franchise and income taxes.

Indeed, nonstatutory options are included in W-2 wages, when exercised to the extent the fair market value at exercise exceeds the grant price. However, the vesting of options creates a compensatory benefit, even if the employee defers the exercise and recognition of that benefit.

Incentive stock options only result in W-2 income if the employee fails to meet the holding requirements. Thus, although the employee

has been “paid” for services rendered, the specific beneficial tax treatment of incentive options results in no W-2 income, and no “wage” expense for the Company.

Since the home office of a QSBS company is in California, the principal officers are usually based there. The vesting and exercise of their options alone comprise substantial California compensation, only a portion of which is reflected in California Schedule 100R.

A Good Sounding *Cantor*

The active business requirement is satisfied if 80 percent of the corporation’s assets are used, and 80 percent of its payroll is employed, in California during substantially all of the taxpayer’s holding period for the stock.

The term “substantially all” is used over 100 times in the Code, nearly always without definition. In many Code provisions, the term “substantially all” is defined as an amount *greater* than 80 percent. However, taxpayers can cite a number of Code sections where “substantially all” is defined as *at least* 80 percent. Some examples follow:

- In Code Sec. 368, “substantially all” is defined as at least 80 percent. [Reg. §1.368-2(d)(2).]
- In Code Sec. 1400L, relating to New York Liberty Zone business credits, “substantially all” is defined as 80 percent or more. [See Notice 2002-42, Q&A 4, IRB 2002-27, 6.]
- Under Code Sec. 170, concerning corporate charitable contributions of scientific property for use in research experimentation or training, “substantially all” is defined to mean at least 80 percent. [S. REP. NO. 97-144, P.L. 97-44, at 89.]
- Code Sec. 302 describes “substantially disproportionate” as less than 80 percent.

California also defines “substantially all” as at least 80 percent (and, in fact, less than 80 percent in some cases):

- In the case of a sale or reorganization of a business, where the business transfers all, or “substantially all,” of the property of the business, for purposes of CR&TC §6006, California defines “substantially all” as 80 percent or more.
- In the case of CR&TC §20509, “substantially equivalent” is defined as at least 80 percent.

[In the Matter of Helen Cantor, Betty M. Asman, and Yakov Kras, 2002 SBE 008 (Nov. 12, 2002) (discussed below).

- Cal. Code Regs., 18 §1595(b)(2) defines “substantially all” to mean at least 80 percent.
- In CR&TC §23251, “substantially all,” for control purposes, is defined as the transfer of at least 80 percent of the properties of another corporation.
- CR&TC §24451 describes “substantially disproportionate” as less than 80 percent.

The California State Board of Equalization (“SBE”) was recently faced with a similar issue in *In the Matter of Helen Cantor, Betty M. Asman, and Yakov Kras* [*supra*] (hereafter, *Cantor*). In *Cantor*, the SBE reviewed the definition of “substantially equivalent” in the context of CR&TC §20509, relating to payments in lieu of property taxes. The SBE sought to define the term by looking to federal and California definitions of “substantially all.” The SBE analyzed California tax law.

A property tax statute relating to the lease-leaseback of publicly owned property defines the term “substantially all” to mean at least 85 percent. [Rev. & Tax. Code, §107.8, subd. (b).] In a sales and use tax statute defining “sale” and “purchase” at a social gathering, “substantially all” is defined as 80 percent or more. [Rev. & Tax. Code, §6010.30, subd. (b).] In a sales tax regulation relating to the transfer of business property, “substantially all property” means 80 percent or more. [Cal. Code Regs., Title 18, §1595, subd. (b)(2).]

As to federal law, Code Sec. 368 says that a transfer of “substantially all” of a corporation’s property may be satisfied by a transfer of 80 percent of fair market value. [Reg. §1.368-2(d)(2).] For purposes of the Code Sec. 521 tax exemption for farmers’ cooperatives, shareholder-producers who own 85 percent of the voting stock own “substantially all” of the cooperative. [Rev. Rul. 73-248, 1973-1 CB 295.] In *Cantor*, the SBE thus set on at least 80 percent. Using the SBE’s analysis in *Cantor*, the SBE might conclude that the term “substantially all” could “be reasonably defined as at least 80 percent.”

Part III of this three-part article will be published in the January 2006 issue of the M&A TAX REPORT.