

**ASSEMBLY BILL**

**No. 901**

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**Introduced by Assembly Member Wieckowski**

February 22, 2013

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An act to repeal and add Sections 18038.5 and 18152.5 of the Revenue and Taxation Code, relating to taxation, making an appropriation therefor, and declaring the urgency thereof, to take effect immediately.

LEGISLATIVE COUNSEL'S DIGEST

AB 901, as introduced, Wieckowski. Income taxes: exclusion: qualified small business stock.

The Personal Income Tax Law, in modified conformity with federal law, provides various exclusions from gross income in computing tax liability.

This bill would, in modified conformity with federal income tax law, provide that gross income does not include 50% of any gain from the sale or exchange of qualified small business stock, as defined, held for more than 5 years, as provided.

This bill would declare that the retroactive application of this provision serves a public purpose.

This bill would make an appropriation from the General Fund of an amount sufficient to make the refunds required pursuant to the changes in law made by this act, including by providing for the waiver of interest and penalties.

This bill would declare that it is to take effect immediately as an urgency statute.

Vote:  $\frac{2}{3}$ . Appropriation: yes. Fiscal committee: yes.  
State-mandated local program: no.

*The people of the State of California do enact as follows:*

1 SECTION 1. Section 18038.5 of the Revenue and Taxation  
2 Code is repealed.

3 ~~18038.5. (a) In the case of any sale of qualified small business~~  
4 ~~stock held by a taxpayer other than a corporation for more than~~  
5 ~~six months and with respect to which that taxpayer elects the~~  
6 ~~application of this section, gain from that sale shall be recognized~~  
7 ~~only to the extent that the amount realized on that sale exceeds:~~

8 ~~(1) The cost of any qualified small business stock purchased by~~  
9 ~~the taxpayer during the 60-day period beginning on the date of~~  
10 ~~that sale, reduced by~~

11 ~~(2) Any portion of the cost previously taken into account under~~  
12 ~~this section.~~

13 ~~This section shall not apply to any gain that is treated as ordinary~~  
14 ~~income for purposes of this part.~~

15 ~~(b) For purposes of this section:~~

16 ~~(1) The term “qualified small business stock” has the meaning~~  
17 ~~given that term by subdivision (e) of Section 18152.5.~~

18 ~~(2) A taxpayer shall be treated as having purchased any property~~  
19 ~~if, but for paragraph (3), the unadjusted basis of that property in~~  
20 ~~the hands of the taxpayer would be its cost (within the meaning~~  
21 ~~of Section 1012 of the Internal Revenue Code).~~

22 ~~(3) If gain from any sale is not recognized by reason of~~  
23 ~~subdivision (a), that gain shall be applied to reduce (in the order~~  
24 ~~acquired) the basis for determining gain or loss of any qualified~~  
25 ~~small business stock that is purchased by the taxpayer during the~~  
26 ~~60-day period described in subdivision (a).~~

27 ~~(4) For purposes of determining whether the nonrecognition of~~  
28 ~~gain under subdivision (a) applies to stock that is sold, both of the~~  
29 ~~following shall apply:~~

30 ~~(A) The taxpayer’s holding period for that stock and the stock~~  
31 ~~referred to in paragraph (1) of subdivision (a) shall be determined~~  
32 ~~without regard to Section 1223 of the Internal Revenue Code.~~

33 ~~(B) Only the first six months of the taxpayer’s holding period~~  
34 ~~for the stock referred to in paragraph (1) of subdivision (a) shall~~  
35 ~~be taken into account for purposes of applying paragraph (2) of~~  
36 ~~subdivision (e) of Section 18152.5.~~

37 ~~(5) Rules similar to the rules of subdivisions (f), (g), (h), (i), (j),~~  
38 ~~and (k) of Section 18152.5 shall apply.~~

1 ~~(e) This section shall apply to sales made after August 5, 1997.~~

2 SEC. 2. Section 18038.5 is added to the Revenue and Taxation  
3 Code, to read:

4 18038.5. (a) In the case of any sale of qualified small business  
5 stock held by a taxpayer other than a corporation for more than  
6 six months and with respect to which that taxpayer elects the  
7 application of this section, gain from that sale shall be recognized  
8 only to the extent that the amount realized on that sale exceeds:

9 (1) The cost of any qualified small business stock purchased by  
10 the taxpayer during the 60-day period beginning on the date of  
11 that sale, reduced by

12 (2) Any portion of the cost previously taken into account under  
13 this section.

14 This section shall not apply to any gain that is treated as ordinary  
15 income for purposes of this part.

16 (b) For purposes of this section:

17 (1) The term “qualified small business stock” has the meaning  
18 given that term by subdivision (c) of Section 18152.5.

19 (2) A taxpayer shall be treated as having purchased any property  
20 if, but for paragraph (3), the unadjusted basis of that property in  
21 the hands of the taxpayer would be its cost (within the meaning  
22 of Section 1012 of the Internal Revenue Code).

23 (3) If gain from any sale is not recognized by reason of  
24 subdivision (a), that gain shall be applied to reduce (in the order  
25 acquired) the basis for determining gain or loss of any qualified  
26 small business stock that is purchased by the taxpayer during the  
27 60-day period described in subdivision (a).

28 (4) For purposes of determining whether the nonrecognition of  
29 gain under subdivision (a) applies to stock that is sold, both of the  
30 following shall apply:

31 (A) The taxpayer’s holding period for that stock and the stock  
32 referred to in paragraph (1) of subdivision (a) shall be determined  
33 without regard to Section 1223 of the Internal Revenue Code.

34 (B) Only the first six months of the taxpayer’s holding period  
35 for the stock referred to in paragraph (1) of subdivision (a) shall  
36 be taken into account for purposes of applying paragraph (2) of  
37 subdivision (c) of Section 18152.5.

38 (5) Rules similar to the rules of subdivisions (f), (g), (h), (i), (j),  
39 and (k) of Section 18152.5 shall apply.

40 (c) This section shall apply to sales made after August 5, 1997.

1 SEC. 3. Section 18152.5 of the Revenue and Taxation Code  
2 is repealed.

3 ~~18152.5. (a) For purposes of this part, gross income shall not~~  
4 ~~include 50 percent of any gain from the sale or exchange of~~  
5 ~~qualified small business stock held for more than five years.~~

6 ~~(b) (1) If the taxpayer has eligible gain for the taxable year~~  
7 ~~from one or more dispositions of stock issued by any corporation,~~  
8 ~~the aggregate amount of the gain from dispositions of stock issued~~  
9 ~~by the corporation which may be taken into account under~~  
10 ~~subdivision (a) for the taxable year shall not exceed the greater of~~  
11 ~~either of the following:~~

12 ~~(A) Ten million dollars (\$10,000,000) reduced by the aggregate~~  
13 ~~amount of eligible gain taken into account by the taxpayer under~~  
14 ~~subdivision (a) for prior taxable years and attributable to~~  
15 ~~dispositions of stock issued by the corporation.~~

16 ~~(B) Ten times the aggregate adjusted bases of qualified small~~  
17 ~~business stock issued by the corporation and disposed of by the~~  
18 ~~taxpayer during the taxable year. For purposes of subparagraph~~  
19 ~~(B), the adjusted basis of any stock shall be determined without~~  
20 ~~regard to any addition to basis after the date on which the stock~~  
21 ~~was originally issued.~~

22 ~~(2) For purposes of this subdivision, the term “eligible gain”~~  
23 ~~means any gain from the sale or exchange of qualified small~~  
24 ~~business stock held for more than five years.~~

25 ~~(3) (A) In the case of a married individual filing a separate~~  
26 ~~return, subparagraph (A) of paragraph (1) shall be applied by~~  
27 ~~substituting five million dollars (\$5,000,000) for ten million dollars~~  
28 ~~(\$10,000,000).~~

29 ~~(B) In the case of a married taxpayer filing a joint return, the~~  
30 ~~amount of gain taken into account under subdivision (a) shall be~~  
31 ~~allocated equally between the spouses for purposes of applying~~  
32 ~~this subdivision to subsequent taxable years.~~

33 ~~(C) For purposes of this subdivision, marital status shall be~~  
34 ~~determined under Section 7703 of the Internal Revenue Code.~~

35 ~~(e) For purposes of this section:~~

36 ~~(1) Except as otherwise provided in this section, the term~~  
37 ~~“qualified small business stock” means any stock in a C corporation~~  
38 ~~which is originally issued after August 10, 1993, if both of the~~  
39 ~~following apply:~~

1 ~~(A) As of the date of issuance, the corporation is a qualified~~  
2 ~~small business.~~

3 ~~(B) Except as provided in subdivisions (f) and (h), the stock is~~  
4 ~~acquired by the taxpayer at its original issue (directly or through~~  
5 ~~an underwriter) in either of the following manners:~~

6 ~~(i) In exchange for money or other property (not including~~  
7 ~~stock).~~

8 ~~(ii) As compensation for services provided to the corporation~~  
9 ~~(other than services performed as an underwriter of the stock).~~

10 ~~(2) (A) Stock in a corporation shall not be treated as qualified~~  
11 ~~small business stock unless, during substantially all of the~~  
12 ~~taxpayer's holding period for the stock, the corporation meets the~~  
13 ~~active business requirements of subdivision (e) and the corporation~~  
14 ~~is a C corporation.~~

15 ~~(B) (i) Notwithstanding subdivision (e), a corporation shall be~~  
16 ~~treated as meeting the active business requirements of subdivision~~  
17 ~~(e) for any period during which the corporation qualifies as a~~  
18 ~~specialized small business investment company.~~

19 ~~(ii) For purposes of clause (i), the term "specialized small~~  
20 ~~business investment company" means any eligible corporation (as~~  
21 ~~defined in paragraph (4) of subdivision (e)) that is licensed to~~  
22 ~~operate under Section 301(d) of the Small Business Investment~~  
23 ~~Act of 1958 (as in effect on May 13, 1993).~~

24 ~~(3) (A) Stock acquired by the taxpayer shall not be treated as~~  
25 ~~qualified small business stock if, at any time during the four-year~~  
26 ~~period beginning on the date two years before the issuance of the~~  
27 ~~stock, the corporation issuing the stock purchased (directly or~~  
28 ~~indirectly) any of its stock from the taxpayer or from a related~~  
29 ~~person (within the meaning of Section 267(b) or 707(b)) to the~~  
30 ~~taxpayer.~~

31 ~~(B) Stock issued by a corporation shall not be treated as qualified~~  
32 ~~small business stock if, during the two-year period beginning on~~  
33 ~~the date one year before the issuance of the stock, the corporation~~  
34 ~~made one or more purchases of its stock with an aggregate value~~  
35 ~~(as of the time of the respective purchases) exceeding 5 percent~~  
36 ~~of the aggregate value of all of its stock as of the beginning of the~~  
37 ~~two-year period.~~

38 ~~(C) If any transaction is treated under Section 304(a) of the~~  
39 ~~Internal Revenue Code as a distribution in redemption of the stock~~  
40 ~~of any corporation, for purposes of subparagraphs (A) and (B), the~~

1 corporation shall be treated as purchasing an amount of its stock  
2 equal to the amount treated as a distribution in redemption of the  
3 stock of the corporation under Section 304(a) of the Internal  
4 Revenue Code.

5 (d) For purposes of this section:

6 (1) The term “qualified small business” means any domestic  
7 corporation (as defined in Section 7701(a)(4) of the Internal  
8 Revenue Code) which is a C corporation if all of the following  
9 apply:

10 (A) The aggregate gross assets of the corporation (or any  
11 predecessor thereof) at all times on or after July 1, 1993, and before  
12 the issuance did not exceed fifty million dollars (\$50,000,000).

13 (B) The aggregate gross assets of the corporation immediately  
14 after the issuance (determined by taking into account amounts  
15 received in the issuance) do not exceed fifty million dollars  
16 (\$50,000,000).

17 (C) At least 80 percent of the corporation’s payroll, as measured  
18 by total dollar value, is attributable to employment located within  
19 California.

20 (D) The corporation agrees to submit those reports to the  
21 Franchise Tax Board and to shareholders as the Franchise Tax  
22 Board may require to carry out the purposes of this section.

23 (2) (A) For purposes of paragraph (1), the term “aggregate  
24 gross assets” means the amount of cash and the aggregate adjusted  
25 basis of other property held by the corporation.

26 (B) For purposes of subparagraph (A), the adjusted basis of any  
27 property contributed to the corporation (or other property with a  
28 basis determined in whole or in part by reference to the adjusted  
29 basis of property so contributed) shall be determined as if the basis  
30 of the property contributed to the corporation immediately after  
31 the contribution was equal to its fair market value as of the time  
32 of the contribution.

33 (3) (A) All corporations which are members of the same  
34 parent-subsidiary controlled group shall be treated as one  
35 corporation for purposes of this subdivision.

36 (B) For purposes of subparagraph (A), the term  
37 “parent-subsidiary controlled group” means any controlled group  
38 of corporations as defined in Section 1563(a)(1) of the Internal  
39 Revenue Code, except that both of the following shall apply:

- 1 (i) ~~“More than 50 percent” shall be substituted for “at least 80~~  
2 ~~percent” each place it appears in Section 1563(a)(1) of the Internal~~  
3 ~~Revenue Code.~~
- 4 (ii) ~~Section 1563(a)(4) of the Internal Revenue Code shall not~~  
5 ~~apply.~~
- 6 (e) ~~(1) For purposes of paragraph (2) of subdivision (e), the~~  
7 ~~requirements of this subdivision are met by a corporation for any~~  
8 ~~period if during that period both of the following apply:~~
- 9 (A) ~~At least 80 percent (by value) of the assets of the corporation~~  
10 ~~are used by the corporation in the active conduct of one or more~~  
11 ~~qualified trades or businesses in California.~~
- 12 (B) ~~The corporation is an eligible corporation.~~
- 13 (2) ~~For purposes of paragraph (1), if, in connection with any~~  
14 ~~future qualified trade or business, a corporation is engaged in:~~
- 15 (A) ~~Startup activities described in Section 195(c)(1)(A) of the~~  
16 ~~Internal Revenue Code,~~
- 17 (B) ~~Activities resulting in the payment or incurring of~~  
18 ~~expenditures which may be treated as research and experimental~~  
19 ~~expenditures under Section 174 of the Internal Revenue Code, or~~
- 20 (C) ~~Activities with respect to in-house research expenses~~  
21 ~~described in Section 41(b)(4) of the Internal Revenue Code, then~~  
22 ~~assets used in those activities shall be treated as used in the active~~  
23 ~~conduct of a qualified trade or business. Any determination under~~  
24 ~~this paragraph shall be made without regard to whether a~~  
25 ~~corporation has any gross income from those activities at the time~~  
26 ~~of the determination.~~
- 27 (3) ~~For purposes of this subdivision, the term “qualified trade~~  
28 ~~or business” means any trade or business other than any of the~~  
29 ~~following:~~
- 30 (A) ~~Any trade or business involving the performance of services~~  
31 ~~in the fields of health, law, engineering, architecture, accounting,~~  
32 ~~actuarial science, performing arts, consulting, athletics, financial~~  
33 ~~services, brokerage services, or any trade or business where the~~  
34 ~~principal asset of the trade or business is the reputation or skill of~~  
35 ~~one or more of its employees.~~
- 36 (B) ~~Any banking, insurance, financing, leasing, investing, or~~  
37 ~~similar business.~~
- 38 (C) ~~Any farming business (including the business of raising or~~  
39 ~~harvesting trees).~~

1 ~~(D) Any business involving the production or extraction of~~  
2 ~~products of a character with respect to which a deduction is~~  
3 ~~allowable under Section 613 or 613A of the Internal Revenue~~  
4 ~~Code.~~

5 ~~(E) Any business of operating a hotel, motel, restaurant, or~~  
6 ~~similar business.~~

7 ~~(4) For purposes of this subdivision, the term “eligible~~  
8 ~~corporation” means any domestic corporation, except that the term~~  
9 ~~shall not include any of the following:~~

10 ~~(A) A DISC or former DISC.~~

11 ~~(B) A corporation with respect to which an election under~~  
12 ~~Section 936 of the Internal Revenue Code is in effect or which has~~  
13 ~~a direct or indirect subsidiary with respect to which the election~~  
14 ~~is in effect.~~

15 ~~(C) A regulated investment company, real estate investment~~  
16 ~~trust (REIT), or real estate mortgage investment conduit (REMIC).~~

17 ~~(D) A cooperative.~~

18 ~~(5) (A) For purposes of this subdivision, stock and debt in any~~  
19 ~~subsidiary corporation shall be disregarded and the parent~~  
20 ~~corporation shall be deemed to own its ratable share of the~~  
21 ~~subsidiary’s assets, and to conduct its ratable share of the~~  
22 ~~subsidiary’s activities.~~

23 ~~(B) A corporation shall be treated as failing to meet the~~  
24 ~~requirements of paragraph (1) for any period during which more~~  
25 ~~than 10 percent of the value of its assets (in excess of liabilities)~~  
26 ~~consists of stock or securities in other corporations which are not~~  
27 ~~subsidiaries of the corporation (other than assets described in~~  
28 ~~paragraph (6)).~~

29 ~~(C) For purposes of this paragraph, a corporation shall be~~  
30 ~~considered a subsidiary if the parent owns more than 50 percent~~  
31 ~~of the combined voting power of all classes of stock entitled to~~  
32 ~~vote, or more than 50 percent in value of all outstanding stock, of~~  
33 ~~the corporation.~~

34 ~~(6) For purposes of subparagraph (A) of paragraph (1), the~~  
35 ~~following assets shall be treated as used in the active conduct of~~  
36 ~~a qualified trade or business:~~

37 ~~(A) Assets that are held as a part of the reasonably required~~  
38 ~~working capital needs of a qualified trade or business of the~~  
39 ~~corporation.~~

1 ~~(B) Assets that are held for investment and are reasonably~~  
2 ~~expected to be used within two years to finance research and~~  
3 ~~experimentation in a qualified trade or business or increases in~~  
4 ~~working capital needs of a qualified trade or business. For periods~~  
5 ~~after the corporation has been in existence for at least two years,~~  
6 ~~in no event may more than 50 percent of the assets of the~~  
7 ~~corporation qualify as used in the active conduct of a qualified~~  
8 ~~trade or business by reason of this paragraph.~~

9 ~~(7) A corporation shall not be treated as meeting the~~  
10 ~~requirements of paragraph (1) for any period during which more~~  
11 ~~than 10 percent of the total value of its assets consists of real~~  
12 ~~property that is not used in the active conduct of a qualified trade~~  
13 ~~or business. For purposes of the preceding sentence, the ownership~~  
14 ~~of, dealing in, or renting of, real property shall not be treated as~~  
15 ~~the active conduct of a qualified trade or business.~~

16 ~~(8) For purposes of paragraph (1), rights to computer software~~  
17 ~~that produces active business computer software royalties (within~~  
18 ~~the meaning of Section 543(d)(1) of the Internal Revenue Code)~~  
19 ~~shall be treated as an asset used in the active conduct of a trade or~~  
20 ~~business.~~

21 ~~(9) A corporation shall not be treated as meeting the~~  
22 ~~requirements of paragraph (1) for any period during which more~~  
23 ~~than 20 percent of the corporation's total payroll expense is~~  
24 ~~attributable to employment located outside of California.~~

25 ~~(f) If any stock in a corporation is acquired solely through the~~  
26 ~~conversion of other stock in the corporation that is qualified small~~  
27 ~~business stock in the hands of the taxpayer, both of the following~~  
28 ~~shall apply:~~

29 ~~(1) The stock so acquired shall be treated as qualified small~~  
30 ~~business stock in the hands of the taxpayer.~~

31 ~~(2) The stock so acquired shall be treated as having been held~~  
32 ~~during the period during which the converted stock was held.~~

33 ~~(g) (1) If any amount included in gross income by reason of~~  
34 ~~holding an interest in a pass-through entity meets the requirements~~  
35 ~~of paragraph (2), then both of the following shall apply:~~

36 ~~(A) The amount shall be treated as gain described in subdivision~~  
37 ~~(a).~~

38 ~~(B) For purposes of applying subdivision (b), the amount shall~~  
39 ~~be treated as gain from a disposition of stock in the corporation~~  
40 ~~issuing the stock disposed of by the pass-through entity and the~~

1 taxpayer's proportionate share of the adjusted basis of the  
2 pass-through entity in the stock shall be taken into account.

3 (2) An amount meets the requirements of this paragraph if both  
4 of the following apply:

5 (A) The amount is attributable to gain on the sale or exchange  
6 by the pass-through entity of stock that is qualified small business  
7 stock in the hands of the entity (determined by treating the entity  
8 as an individual) and that was held by that entity for more than  
9 five years.

10 (B) The amount is includable in the gross income of the taxpayer  
11 by reason of the holding of an interest in the entity that was held  
12 by the taxpayer on the date on which the pass-through entity  
13 acquired the stock and at all times thereafter before the disposition  
14 of the stock by the pass-through entity.

15 (3) Paragraph (1) shall not apply to any amount to the extent  
16 the amount exceeds the amount to which paragraph (1) would have  
17 applied if the amount was determined by reference to the interest  
18 the taxpayer held in the pass-through entity on the date the qualified  
19 small business stock was acquired.

20 (4) For purposes of this subdivision, the term "pass-through  
21 entity" means any of the following:

22 (A) Any partnership.

23 (B) Any S corporation.

24 (C) Any regulated investment company.

25 (D) Any common trust fund.

26 (h) For purposes of this section:

27 (1) In the case of a transfer described in paragraph (2), the  
28 transferee shall be treated as meeting both of the following:

29 (A) Having acquired the stock in the same manner as the  
30 transferor.

31 (B) Having held the stock during any continuous period  
32 immediately preceding the transfer during which it was held (or  
33 treated as held under this subdivision) by the transferor.

34 (2) A transfer is described in this subdivision if the transfer is  
35 any of the following:

36 (A) By gift.

37 (B) At death.

38 (C) From a partnership to a partner of stock with respect to  
39 which requirements similar to the requirements of subdivision (g)

1 are met at the time of the transfer (without regard to the five-year  
2 holding period requirement):

3 ~~(3) Rules similar to the rules of Section 1244(d)(2) of the~~  
4 ~~Internal Revenue Code shall apply for purposes of this section.~~

5 ~~(4) (A) In the case of a transaction described in Section 351 of~~  
6 ~~the Internal Revenue Code or a reorganization described in Section~~  
7 ~~368 of the Internal Revenue Code, if qualified small business stock~~  
8 ~~is exchanged for other stock that would not qualify as qualified~~  
9 ~~small business stock but for this subparagraph, the other stock~~  
10 ~~shall be treated as qualified small business stock acquired on the~~  
11 ~~date on which the exchanged stock was acquired.~~

12 ~~(B) This section shall apply to gain from the sale or exchange~~  
13 ~~of stock treated as qualified small business stock by reason of~~  
14 ~~subparagraph (A) only to the extent of the gain that would have~~  
15 ~~been recognized at the time of the transfer described in~~  
16 ~~subparagraph (A) if Section 351 or 368 of the Internal Revenue~~  
17 ~~Code had not applied at that time. The preceding sentence shall~~  
18 ~~not apply if the stock that is treated as qualified small business~~  
19 ~~stock by reason of subparagraph (A) is issued by a corporation~~  
20 ~~that (as of the time of the transfer described in subparagraph (A))~~  
21 ~~is a qualified small business.~~

22 ~~(C) For purposes of this paragraph, stock treated as qualified~~  
23 ~~small business stock under subparagraph (A) shall be so treated~~  
24 ~~for subsequent transactions or reorganizations, except that the~~  
25 ~~limitation of subparagraph (B) shall be applied as of the time of~~  
26 ~~the first transfer to which the limitation applied (determined after~~  
27 ~~the application of the second sentence of subparagraph (B)).~~

28 ~~(D) In the case of a transaction described in Section 351 of the~~  
29 ~~Internal Revenue Code, this paragraph shall apply only if~~  
30 ~~immediately after the transaction the corporation issuing the stock~~  
31 ~~owns directly or indirectly stock representing control (within the~~  
32 ~~meaning of Section 368(c) of the Internal Revenue Code) of the~~  
33 ~~corporation whose stock was exchanged.~~

34 ~~(i) For purposes of this section:~~

35 ~~(1) In the case where the taxpayer transfers property (other than~~  
36 ~~money or stock) to a corporation in exchange for stock in the~~  
37 ~~corporation, both of the following shall apply:~~

38 ~~(A) The stock shall be treated as having been acquired by the~~  
39 ~~taxpayer on the date of the exchange.~~

1 ~~(B) The basis of the stock in the hands of the taxpayer shall in~~  
2 ~~no event be less than the fair market value of the property~~  
3 ~~exchanged.~~

4 ~~(2) If the adjusted basis of any qualified small business stock~~  
5 ~~is adjusted by reason of any contribution to capital after the date~~  
6 ~~on which the stock was originally issued, in determining the~~  
7 ~~amount of the adjustment by reason of the contribution, the basis~~  
8 ~~of the contributed property shall in no event be treated as less than~~  
9 ~~its fair market value on the date of the contribution.~~

10 ~~(j) (1) If the taxpayer has an offsetting short position with~~  
11 ~~respect to any qualified small business stock, subdivision (a) shall~~  
12 ~~not apply to any gain from the sale or exchange of the stock unless~~  
13 ~~both of the following apply:~~

14 ~~(A) The stock was held by the taxpayer for more than five years~~  
15 ~~as of the first day on which there was such a short position.~~

16 ~~(B) The taxpayer elects to recognize gain as if the stock was~~  
17 ~~sold on that first day for its fair market value.~~

18 ~~(2) For purposes of paragraph (1), the taxpayer shall be treated~~  
19 ~~as having an offsetting short position with respect to any qualified~~  
20 ~~small business stock if any of the following apply:~~

21 ~~(A) The taxpayer has made a short sale of substantially identical~~  
22 ~~property.~~

23 ~~(B) The taxpayer has acquired an option to sell substantially~~  
24 ~~identical property at a fixed price.~~

25 ~~(C) To the extent provided in regulations, the taxpayer has~~  
26 ~~entered into any other transaction that substantially reduces the~~  
27 ~~risk of loss from holding the qualified small business stock. For~~  
28 ~~purposes of the preceding sentence, any reference to the taxpayer~~  
29 ~~shall be treated as including a reference to any person who is~~  
30 ~~related (within the meaning of Section 267(b) or 707(b) of the~~  
31 ~~Internal Revenue Code) to the taxpayer.~~

32 ~~(k) The Franchise Tax Board may prescribe those regulations~~  
33 ~~as may be appropriate to carry out the purposes of this section,~~  
34 ~~including regulations to prevent the avoidance of the purposes of~~  
35 ~~this section through splitups, shell corporations, partnerships, or~~  
36 ~~otherwise.~~

37 ~~(l) It is the intent of the Legislature that, in construing this~~  
38 ~~section, any regulations that may be promulgated by the Secretary~~  
39 ~~of the Treasury under Section 1202(k) of the Internal Revenue~~  
40 ~~Code shall apply to the extent that those regulations do not conflict~~

1 ~~with this section or with any regulations that may be promulgated~~  
2 ~~by the Franchise Tax Board.~~

3 SEC. 4. Section 18152.5 is added to the Revenue and Taxation  
4 Code, to read:

5 18152.5. (a) For purposes of this part, gross income shall not  
6 include 50 percent of any gain from the sale or exchange of  
7 qualified small business stock held for more than five years.

8 (b) (1) If the taxpayer has eligible gain for the taxable year  
9 from one or more dispositions of stock issued by any corporation,  
10 the aggregate amount of the gain from dispositions of stock issued  
11 by the corporation which may be taken into account under  
12 subdivision (a) for the taxable year shall not exceed the greater of  
13 either of the following:

14 (A) Ten million dollars (\$10,000,000) reduced by the aggregate  
15 amount of eligible gain taken into account by the taxpayer under  
16 subdivision (a) for prior taxable years and attributable to  
17 dispositions of stock issued by the corporation.

18 (B) Ten times the aggregate adjusted bases of qualified small  
19 business stock issued by the corporation and disposed of by the  
20 taxpayer during the taxable year. For purposes of subparagraph  
21 (B), the adjusted basis of any stock shall be determined without  
22 regard to any addition to basis after the date on which the stock  
23 was originally issued.

24 (2) For purposes of this subdivision, the term “eligible gain”  
25 means any gain from the sale or exchange of qualified small  
26 business stock held for more than five years.

27 (3) (A) In the case of a married individual filing a separate  
28 return, subparagraph (A) of paragraph (1) shall be applied by  
29 substituting five million dollars (\$5,000,000) for ten million dollars  
30 (\$10,000,000).

31 (B) In the case of a married taxpayer filing a joint return, the  
32 amount of gain taken into account under subdivision (a) shall be  
33 allocated equally between the spouses for purposes of applying  
34 this subdivision to subsequent taxable years.

35 (C) For purposes of this subdivision, marital status shall be  
36 determined under Section 7703 of the Internal Revenue Code.

37 (c) For purposes of this section:

38 (1) Except as otherwise provided in this section, the term  
39 “qualified small business stock” means any stock in a C corporation

1 which is originally issued after August 10, 1993, if both of the  
2 following apply:

3 (A) As of the date of issuance, the corporation is a qualified  
4 small business.

5 (B) Except as provided in subdivisions (f) and (h), the stock is  
6 acquired by the taxpayer at its original issue (directly or through  
7 an underwriter) in either of the following manners:

8 (i) In exchange for money or other property (not including  
9 stock).

10 (ii) As compensation for services provided to the corporation  
11 (other than services performed as an underwriter of the stock).

12 (2) (A) Stock in a corporation shall not be treated as qualified  
13 small business stock unless, during substantially all of the  
14 taxpayer's holding period for the stock, the corporation meets the  
15 active business requirements of subdivision (e) and the corporation  
16 is a C corporation.

17 (B) (i) Notwithstanding subdivision (e), a corporation shall be  
18 treated as meeting the active business requirements of subdivision  
19 (e) for any period during which the corporation qualifies as a  
20 specialized small business investment company.

21 (ii) For purposes of clause (i), the term "specialized small  
22 business investment company" means any eligible corporation (as  
23 defined in paragraph (4) of subdivision (e)) that is licensed to  
24 operate under Section 301(d) of the Small Business Investment  
25 Act of 1958 (as in effect on May 13, 1993).

26 (3) (A) Stock acquired by the taxpayer shall not be treated as  
27 qualified small business stock if, at any time during the four-year  
28 period beginning on the date two years before the issuance of the  
29 stock, the corporation issuing the stock purchased (directly or  
30 indirectly) any of its stock from the taxpayer or from a related  
31 person (within the meaning of Section 267(b) or 707(b)) to the  
32 taxpayer.

33 (B) Stock issued by a corporation shall not be treated as qualified  
34 small business stock if, during the two-year period beginning on  
35 the date one year before the issuance of the stock, the corporation  
36 made one or more purchases of its stock with an aggregate value  
37 (as of the time of the respective purchases) exceeding 5 percent  
38 of the aggregate value of all of its stock as of the beginning of the  
39 two-year period.

1 (C) If any transaction is treated under Section 304(a) of the  
2 Internal Revenue Code as a distribution in redemption of the stock  
3 of any corporation, for purposes of subparagraphs (A) and (B), the  
4 corporation shall be treated as purchasing an amount of its stock  
5 equal to the amount treated as a distribution in redemption of the  
6 stock of the corporation under Section 304(a) of the Internal  
7 Revenue Code.

8 (d) For purposes of this section:

9 (1) The term “qualified small business” means any domestic  
10 corporation (as defined in Section 7701(a)(4) of the Internal  
11 Revenue Code) which is a C corporation if all of the following  
12 apply:

13 (A) The aggregate gross assets of the corporation (or any  
14 predecessor thereof) at all times on or after July 1, 1993, and before  
15 the issuance did not exceed fifty million dollars (\$50,000,000).

16 (B) The aggregate gross assets of the corporation immediately  
17 after the issuance (determined by taking into account amounts  
18 received in the issuance) do not exceed fifty million dollars  
19 (\$50,000,000).

20 (C) The corporation agrees to submit those reports to the  
21 Franchise Tax Board and to shareholders as the Franchise Tax  
22 Board may require to carry out the purposes of this section.

23 (2) (A) For purposes of paragraph (1), the term “aggregate  
24 gross assets” means the amount of cash and the aggregate adjusted  
25 basis of other property held by the corporation.

26 (B) For purposes of subparagraph (A), the adjusted basis of any  
27 property contributed to the corporation (or other property with a  
28 basis determined in whole or in part by reference to the adjusted  
29 basis of property so contributed) shall be determined as if the basis  
30 of the property contributed to the corporation immediately after  
31 the contribution was equal to its fair market value as of the time  
32 of the contribution.

33 (3) (A) All corporations which are members of the same  
34 parent-subsidiary controlled group shall be treated as one  
35 corporation for purposes of this subdivision.

36 (B) For purposes of subparagraph (A), the term  
37 “parent-subsidiary controlled group” means any controlled group  
38 of corporations as defined in Section 1563(a)(1) of the Internal  
39 Revenue Code, except that both of the following shall apply:

- 1 (i) “More than 50 percent” shall be substituted for “at least 80  
 2 percent” each place it appears in Section 1563(a)(1) of the Internal  
 3 Revenue Code.
- 4 (ii) Section 1563(a)(4) of the Internal Revenue Code shall not  
 5 apply.
- 6 (e) (1) For purposes of paragraph (2) of subdivision (c), the  
 7 requirements of this subdivision are met by a corporation for any  
 8 period if during that period the corporation is an eligible  
 9 corporation.
- 10 (2) For purposes of paragraph (1), if, in connection with any  
 11 future qualified trade or business, a corporation is engaged in:
- 12 (A) Startup activities described in Section 195(c)(1)(A) of the  
 13 Internal Revenue Code,
- 14 (B) Activities resulting in the payment or incurring of  
 15 expenditures which may be treated as research and experimental  
 16 expenditures under Section 174 of the Internal Revenue Code, or
- 17 (C) Activities with respect to in-house research expenses  
 18 described in Section 41(b)(4) of the Internal Revenue Code, then  
 19 assets used in those activities shall be treated as used in the active  
 20 conduct of a qualified trade or business. Any determination under  
 21 this paragraph shall be made without regard to whether a  
 22 corporation has any gross income from those activities at the time  
 23 of the determination.
- 24 (3) For purposes of this subdivision, the term “qualified trade  
 25 or business” means any trade or business other than any of the  
 26 following:
- 27 (A) Any trade or business involving the performance of services  
 28 in the fields of health, law, engineering, architecture, accounting,  
 29 actuarial science, performing arts, consulting, athletics, financial  
 30 services, brokerage services, or any trade or business where the  
 31 principal asset of the trade or business is the reputation or skill of  
 32 one or more of its employees.
- 33 (B) Any banking, insurance, financing, leasing, investing, or  
 34 similar business.
- 35 (C) Any farming business (including the business of raising or  
 36 harvesting trees).
- 37 (D) Any business involving the production or extraction of  
 38 products of a character with respect to which a deduction is  
 39 allowable under Section 613 or 613A of the Internal Revenue  
 40 Code.

1 (E) Any business of operating a hotel, motel, restaurant, or  
2 similar business.

3 (4) For purposes of this subdivision, the term “eligible  
4 corporation” means any domestic corporation, except that the term  
5 shall not include any of the following:

6 (A) A DISC or former DISC.

7 (B) A corporation with respect to which an election under  
8 Section 936 of the Internal Revenue Code is in effect or which has  
9 a direct or indirect subsidiary with respect to which the election  
10 is in effect.

11 (C) A regulated investment company, real estate investment  
12 trust (REIT), or real estate mortgage investment conduit (REMIC).

13 (D) A cooperative.

14 (5) (A) For purposes of this subdivision, stock and debt in any  
15 subsidiary corporation shall be disregarded and the parent  
16 corporation shall be deemed to own its ratable share of the  
17 subsidiary’s assets, and to conduct its ratable share of the  
18 subsidiary’s activities.

19 (B) A corporation shall be treated as failing to meet the  
20 requirements of paragraph (1) for any period during which more  
21 than 10 percent of the value of its assets (in excess of liabilities)  
22 consists of stock or securities in other corporations which are not  
23 subsidiaries of the corporation (other than assets described in  
24 paragraph (6)).

25 (C) For purposes of this paragraph, a corporation shall be  
26 considered a subsidiary if the parent owns more than 50 percent  
27 of the combined voting power of all classes of stock entitled to  
28 vote, or more than 50 percent in value of all outstanding stock, of  
29 the corporation.

30 (6) For purposes of subparagraph (A) of paragraph (1), the  
31 following assets shall be treated as used in the active conduct of  
32 a qualified trade or business:

33 (A) Assets that are held as a part of the reasonably required  
34 working capital needs of a qualified trade or business of the  
35 corporation.

36 (B) Assets that are held for investment and are reasonably  
37 expected to be used within two years to finance research and  
38 experimentation in a qualified trade or business or increases in  
39 working capital needs of a qualified trade or business. For periods  
40 after the corporation has been in existence for at least two years,

1 in no event may more than 50 percent of the assets of the  
2 corporation qualify as used in the active conduct of a qualified  
3 trade or business by reason of this paragraph.

4 (7) A corporation shall not be treated as meeting the  
5 requirements of paragraph (1) for any period during which more  
6 than 10 percent of the total value of its assets consists of real  
7 property that is not used in the active conduct of a qualified trade  
8 or business. For purposes of the preceding sentence, the ownership  
9 of, dealing in, or renting of, real property shall not be treated as  
10 the active conduct of a qualified trade or business.

11 (8) For purposes of paragraph (1), rights to computer software  
12 that produces active business computer software royalties (within  
13 the meaning of Section 543(d)(1) of the Internal Revenue Code)  
14 shall be treated as an asset used in the active conduct of a trade or  
15 business.

16 (f) If any stock in a corporation is acquired solely through the  
17 conversion of other stock in the corporation that is qualified small  
18 business stock in the hands of the taxpayer, both of the following  
19 shall apply:

20 (1) The stock so acquired shall be treated as qualified small  
21 business stock in the hands of the taxpayer.

22 (2) The stock so acquired shall be treated as having been held  
23 during the period during which the converted stock was held.

24 (g) (1) If any amount included in gross income by reason of  
25 holding an interest in a pass-through entity meets the requirements  
26 of paragraph (2), then both of the following shall apply:

27 (A) The amount shall be treated as gain described in subdivision  
28 (a).

29 (B) For purposes of applying subdivision (b), the amount shall  
30 be treated as gain from a disposition of stock in the corporation  
31 issuing the stock disposed of by the pass-through entity and the  
32 taxpayer's proportionate share of the adjusted basis of the  
33 pass-through entity in the stock shall be taken into account.

34 (2) An amount meets the requirements of this paragraph if both  
35 of the following apply:

36 (A) The amount is attributable to gain on the sale or exchange  
37 by the pass-through entity of stock that is qualified small business  
38 stock in the hands of the entity (determined by treating the entity  
39 as an individual) and that was held by that entity for more than  
40 five years.

1 (B) The amount is includable in the gross income of the taxpayer  
2 by reason of the holding of an interest in the entity that was held  
3 by the taxpayer on the date on which the pass-through entity  
4 acquired the stock and at all times thereafter before the disposition  
5 of the stock by the pass-through entity.

6 (3) Paragraph (1) shall not apply to any amount to the extent  
7 the amount exceeds the amount to which paragraph (1) would have  
8 applied if the amount was determined by reference to the interest  
9 the taxpayer held in the pass-through entity on the date the qualified  
10 small business stock was acquired.

11 (4) For purposes of this subdivision, the term “pass-through  
12 entity” means any of the following:

13 (A) Any partnership.

14 (B) Any S corporation.

15 (C) Any regulated investment company.

16 (D) Any common trust fund.

17 (h) For purposes of this section:

18 (1) In the case of a transfer described in paragraph (2), the  
19 transferee shall be treated as meeting both of the following:

20 (A) Having acquired the stock in the same manner as the  
21 transferor.

22 (B) Having held the stock during any continuous period  
23 immediately preceding the transfer during which it was held (or  
24 treated as held under this subdivision) by the transferor.

25 (2) A transfer is described in this subdivision if the transfer is  
26 any of the following:

27 (A) By gift.

28 (B) At death.

29 (C) From a partnership to a partner of stock with respect to  
30 which requirements similar to the requirements of subdivision (g)  
31 are met at the time of the transfer (without regard to the five-year  
32 holding period requirement).

33 (3) Rules similar to the rules of Section 1244(d)(2) of the  
34 Internal Revenue Code shall apply for purposes of this section.

35 (4) (A) In the case of a transaction described in Section 351 of  
36 the Internal Revenue Code or a reorganization described in Section  
37 368 of the Internal Revenue Code, if qualified small business stock  
38 is exchanged for other stock that would not qualify as qualified  
39 small business stock but for this subparagraph, the other stock

1 shall be treated as qualified small business stock acquired on the  
2 date on which the exchanged stock was acquired.

3 (B) This section shall apply to gain from the sale or exchange  
4 of stock treated as qualified small business stock by reason of  
5 subparagraph (A) only to the extent of the gain that would have  
6 been recognized at the time of the transfer described in  
7 subparagraph (A) if Section 351 or 368 of the Internal Revenue  
8 Code had not applied at that time. The preceding sentence shall  
9 not apply if the stock that is treated as qualified small business  
10 stock by reason of subparagraph (A) is issued by a corporation  
11 that (as of the time of the transfer described in subparagraph (A))  
12 is a qualified small business.

13 (C) For purposes of this paragraph, stock treated as qualified  
14 small business stock under subparagraph (A) shall be so treated  
15 for subsequent transactions or reorganizations, except that the  
16 limitation of subparagraph (B) shall be applied as of the time of  
17 the first transfer to which the limitation applied (determined after  
18 the application of the second sentence of subparagraph (B)).

19 (D) In the case of a transaction described in Section 351 of the  
20 Internal Revenue Code, this paragraph shall apply only if  
21 immediately after the transaction the corporation issuing the stock  
22 owns directly or indirectly stock representing control (within the  
23 meaning of Section 368(c) of the Internal Revenue Code) of the  
24 corporation whose stock was exchanged.

25 (i) For purposes of this section:

26 (1) In the case where the taxpayer transfers property (other than  
27 money or stock) to a corporation in exchange for stock in the  
28 corporation, both of the following shall apply:

29 (A) The stock shall be treated as having been acquired by the  
30 taxpayer on the date of the exchange.

31 (B) The basis of the stock in the hands of the taxpayer shall in  
32 no event be less than the fair market value of the property  
33 exchanged.

34 (2) If the adjusted basis of any qualified small business stock  
35 is adjusted by reason of any contribution to capital after the date  
36 on which the stock was originally issued, in determining the  
37 amount of the adjustment by reason of the contribution, the basis  
38 of the contributed property shall in no event be treated as less than  
39 its fair market value on the date of the contribution.

1 (j) (1) If the taxpayer has an offsetting short position with  
2 respect to any qualified small business stock, subdivision (a) shall  
3 not apply to any gain from the sale or exchange of the stock unless  
4 both of the following apply:

5 (A) The stock was held by the taxpayer for more than five years  
6 as of the first day on which there was such a short position.

7 (B) The taxpayer elects to recognize gain as if the stock was  
8 sold on that first day for its fair market value.

9 (2) For purposes of paragraph (1), the taxpayer shall be treated  
10 as having an offsetting short position with respect to any qualified  
11 small business stock if any of the following apply:

12 (A) The taxpayer has made a short sale of substantially identical  
13 property.

14 (B) The taxpayer has acquired an option to sell substantially  
15 identical property at a fixed price.

16 (C) To the extent provided in regulations, the taxpayer has  
17 entered into any other transaction that substantially reduces the  
18 risk of loss from holding the qualified small business stock. For  
19 purposes of the preceding sentence, any reference to the taxpayer  
20 shall be treated as including a reference to any person who is  
21 related (within the meaning of Section 267(b) or 707(b) of the  
22 Internal Revenue Code) to the taxpayer.

23 (k) The Franchise Tax Board may prescribe those regulations  
24 as may be appropriate to carry out the purposes of this section,  
25 including regulations to prevent the avoidance of the purposes of  
26 this section through splitups, shell corporations, partnerships, or  
27 otherwise.

28 (l) It is the intent of the Legislature that, in construing this  
29 section, any regulations that may be promulgated by the Secretary  
30 of the Treasury under Section 1202(k) of the Internal Revenue  
31 Code shall apply to the extent that those regulations do not conflict  
32 with this section or with any regulations that may be promulgated  
33 by the Franchise Tax Board.

34 (m) This section shall apply to each taxable year beginning on  
35 or after January 1, 2008.

36 SEC. 5. There is hereby appropriated from the General Fund  
37 an amount sufficient to make the refunds required pursuant to the  
38 repeal and the addition of Sections 18038.5 and 18152.5 of the  
39 Revenue and Taxation Code made by Sections 1 to 4, inclusive,

1 of this act including by providing for the waiver of interest and  
2 penalties.

3 SEC. 6. The Legislature finds and declares that the retroactive  
4 application of Sections 18038.5 and 18152.5 serves a public  
5 purpose and is necessary to prevent undue hardship to taxpayers  
6 that would otherwise have been subject to taxation, interest, and  
7 penalties through circumstances beyond their control and to provide  
8 relief to taxpayers to rectify any unconstitutional deprivation.

9 SEC. 7. This act is an urgency statute necessary for the  
10 immediate preservation of the public peace, health, or safety within  
11 the meaning of Article IV of the Constitution and shall go into  
12 immediate effect. The facts constituting the necessity are:

13 In order to prevent undue hardship to taxpayers that would  
14 otherwise have been subject to taxation, interest, and penalties  
15 through circumstances beyond their control and to provide relief  
16 to taxpayers to rectify any unconstitutional deprivation, it is  
17 necessary that this act take effect immediately.