

Introduced by Senator Walters

February 21, 2014

An act to amend Sections 18038.5 and 18152.5 of, and to add Sections 18038.6 and 18152.6 to, the Revenue and Taxation Code, relating to taxation, to take effect immediately, tax levy.

LEGISLATIVE COUNSEL'S DIGEST

SB 1386, as introduced, Walters. Income taxes: exclusion: deferral: 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. Existing law provides, in reference to specified federal income tax laws, 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, and requires the qualified small business have at least 80% of its payroll attributable to employment in California. These provisions are repealed on January 1, 2016.

This bill would remove the repeal date of those provisions. This bill would add the same exclusions from gross income as described above for sales made in taxable years beginning on or after January 1, 2015.

This bill would take effect immediately as a tax levy.

Vote: majority. Appropriation: no. 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 amended to read:

1 18038.5. (a) In the case of any sale of qualified small business
2 stock held by a taxpayer other than a corporation for more than
3 six months and with respect to which that taxpayer elects the
4 application of this section, gain from that sale shall be recognized
5 only to the extent that the amount realized on that sale exceeds:

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

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

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

13 (b) For purposes of this section:

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

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

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

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

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

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

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

37 (c) This section shall apply to sales made after August 5, 1997,
38 and before January 1, 2013.

1 ~~(d) This section shall remain in effect only until January 1, 2016,~~
2 ~~and as of that date is repealed, unless a later enacted statute, that~~
3 ~~is enacted before January 1, 2016, deletes or extends that date.~~

4 SEC. 2. Section 18038.6 is added to the Revenue and Taxation
5 Code, to read:

6 18038.6. (a) In the case of any sale of qualified small business
7 stock held by a taxpayer other than a corporation for more than
8 six months and with respect to which that taxpayer elects the
9 application of this section, gain from that sale shall be recognized
10 only to the extent that the amount realized on that sale exceeds:

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

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

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

18 (b) For purposes of this section:

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

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

25 (3) If gain from any sale is not recognized by reason of
26 subdivision (a), that gain shall be applied to reduce (in the order
27 acquired) the basis for determining gain or loss of any qualified
28 small business stock that is purchased by the taxpayer during the
29 60-day period described in subdivision (a).

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

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

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

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

3 (c) This section shall apply to sales, including installment sales,
4 occurring in taxable years beginning on and after January 1, 2015.

5 SEC. 3. Section 18152.5 of the Revenue and Taxation Code
6 is amended to read:

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

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

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

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

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

29 (3) (A) In the case of a married individual filing a separate
30 return, subparagraph (A) of paragraph (1) shall be applied by
31 substituting five million dollars (\$5,000,000) for ten million dollars
32 (\$10,000,000).

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

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

39 (c) For purposes of this section:

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

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

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

10 (i) In exchange for money or other property (not including
11 stock).

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

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

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

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

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

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

1 of the aggregate value of all of its stock as of the beginning of the
2 two-year period.

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

10 (d) For purposes of this section:

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

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

18 (B) The aggregate gross assets of the corporation immediately
19 after the issuance (determined by taking into account amounts
20 received in the issuance) do not exceed fifty million dollars
21 (\$50,000,000).

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

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

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

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

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

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

5 (i) “More than 50 percent” shall be substituted for “at least 80
6 percent” each place it appears in Section 1563(a)(1) of the Internal
7 Revenue Code.

8 (ii) Section 1563(a)(4) of the Internal Revenue Code shall not
9 apply.

10 (e) (1) For purposes of paragraph (2) of subdivision (c), the
11 requirements of this subdivision are met by a corporation for any
12 period if during that period both of the following apply:

13 (A) At least 80 percent (by value) of the assets of the corporation
14 are used by the corporation in the active conduct of one or more
15 qualified trades or businesses.

16 (B) The corporation is an eligible corporation.

17 (2) For purposes of paragraph (1), if, in connection with any
18 future qualified trade or business, a corporation is engaged in *one*
19 *of the following*:

20 (A) Startup activities described in Section 195(c)(1)(A) of the
21 Internal Revenue ~~Code~~, *Code*.

22 (B) Activities resulting in the payment or incurring of
23 expenditures which may be treated as research and experimental
24 expenditures under Section 174 of the Internal Revenue Code, ~~or~~.

25 (C) Activities with respect to in-house research expenses
26 described in Section 41(b)(4) of the Internal Revenue Code, then
27 assets used in those activities shall be treated as used in the active
28 conduct of a qualified trade or business. Any determination under
29 this paragraph shall be made without regard to whether a
30 corporation has any gross income from those activities at the time
31 of the determination.

32 (3) For purposes of this subdivision, the term “qualified trade
33 or business” means any trade or business other than any of the
34 following:

35 (A) Any trade or business involving the performance of services
36 in the fields of health, law, engineering, architecture, accounting,
37 actuarial science, performing arts, consulting, athletics, financial
38 services, brokerage services, or any trade or business where the
39 principal asset of the trade or business is the reputation or skill of
40 one or more of its employees.

- 1 (B) Any banking, insurance, financing, leasing, investing, or
2 similar business.
- 3 (C) Any farming business (including the business of raising or
4 harvesting trees).
- 5 (D) Any business involving the production or extraction of
6 products of a character with respect to which a deduction is
7 allowable under Section 613 or 613A of the Internal Revenue
8 Code.
- 9 (E) Any business of operating a hotel, motel, restaurant, or
10 similar business.
- 11 (4) For purposes of this subdivision, the term “eligible
12 corporation” means any domestic corporation, except that the term
13 shall not include any of the following:
 - 14 (A) A DISC or former DISC.
 - 15 (B) A corporation with respect to which an election under
16 Section 936 of the Internal Revenue Code is in effect or which has
17 a direct or indirect subsidiary with respect to which the election
18 is in effect.
 - 19 (C) A regulated investment company, real estate investment
20 trust (REIT), or real estate mortgage investment conduit (REMIC).
 - 21 (D) A cooperative.
- 22 (5) (A) For purposes of this subdivision, stock and debt in any
23 subsidiary corporation shall be disregarded and the parent
24 corporation shall be deemed to own its ratable share of the
25 subsidiary’s assets, and to conduct its ratable share of the
26 subsidiary’s activities.
- 27 (B) A corporation shall be treated as failing to meet the
28 requirements of paragraph (1) for any period during which more
29 than 10 percent of the value of its assets (in excess of liabilities)
30 consists of stock or securities in other corporations which are not
31 subsidiaries of the corporation (other than assets described in
32 paragraph (6)).
- 33 (C) For purposes of this paragraph, a corporation shall be
34 considered a subsidiary if the parent owns more than 50 percent
35 of the combined voting power of all classes of stock entitled to
36 vote, or more than 50 percent in value of all outstanding stock, of
37 the corporation.
- 38 (6) For purposes of subparagraph (A) of paragraph (1), the
39 following assets shall be treated as used in the active conduct of
40 a qualified trade or business:

1 (A) Assets that are held as a part of the reasonably required
2 working capital needs of a qualified trade or business of the
3 corporation.

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

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

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

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

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

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

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

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

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

1 taxpayer's proportionate share of the adjusted basis of the pass-thru
2 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-thru 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-thru entity acquired
13 the stock and at all times thereafter before the disposition of the
14 stock by the pass-thru 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-thru entity on the date the qualified
19 small business stock was acquired.

20 (4) For purposes of this subdivision, the term "pass-thru entity"
21 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 ~~split-ups~~, *split-ups*, shell corporations,
36 partnerships, or 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 (m) The amendments made to this section by ~~the act adding this~~
4 ~~subdivision Chapter 546 of the Statutes of 2013~~ shall apply to
5 sales, including installment sales, occurring in each taxable year
6 beginning on or after January 1, 2008, and before January 1, 2013,
7 and installment payments received in taxable years beginning on
8 or after January 1, 2008, for sales of qualified small business stock
9 made in taxable years beginning before January 1, 2013.

10 ~~(n) This section shall remain in effect only until January 1, 2016,~~
11 ~~and as of that date is repealed, unless a later enacted statute, that~~
12 ~~is enacted before January 1, 2016, deletes or extends that date.~~

13 SEC. 4. Section 18152.6 is added to the Revenue and Taxation
14 Code, to read:

15 18152.6. (a) For purposes of this part, gross income shall not
16 include 50 percent of any gain from the sale or exchange of
17 qualified small business stock held for more than five years.

18 (b) (1) If the taxpayer has eligible gain for the taxable year from
19 one or more dispositions of stock issued by any corporation, the
20 aggregate amount of the gain from dispositions of stock issued by
21 the corporation which may be taken into account under subdivision
22 (a) for the taxable year shall not exceed the greater of either of the
23 following:

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

28 (B) Ten times the aggregate adjusted bases of qualified small
29 business stock issued by the corporation and disposed of by the
30 taxpayer during the taxable year. For purposes of subparagraph
31 (B), the adjusted basis of any stock shall be determined without
32 regard to any addition to basis after the date on which the stock
33 was originally issued.

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

37 (3) (A) In the case of a married individual filing a separate
38 return, subparagraph (A) of paragraph (1) shall be applied by
39 substituting five million dollars (\$5,000,000) for ten million dollars
40 (\$10,000,000).

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

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

7 (c) For purposes of this section:

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

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

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

17 (i) In exchange for money or other property (not including
18 stock).

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

21 (2) (A) Stock in a corporation shall not be treated as qualified
22 small business stock unless, during substantially all of the
23 taxpayer’s holding period for the stock, the corporation meets the
24 active business requirements of subdivision (e) and the corporation
25 is a C corporation.

26 (B) (i) Notwithstanding subdivision (e), a corporation shall be
27 treated as meeting the active business requirements of subdivision
28 (e) for any period during which the corporation qualifies as a
29 specialized small business investment company.

30 (ii) For purposes of clause (i), the term “specialized small
31 business investment company” means any eligible corporation (as
32 defined in paragraph (4) of subdivision (e)) that is licensed to
33 operate under Section 301(d) of the Small Business Investment
34 Act of 1958 (as in effect on May 13, 1993).

35 (3) (A) Stock acquired by the taxpayer shall not be treated as
36 qualified small business stock if, at any time during the four-year
37 period beginning on the date two years before the issuance of the
38 stock, the corporation issuing the stock purchased (directly or
39 indirectly) any of its stock from the taxpayer or from a related

1 person (within the meaning of Section 267(b) or 707(b)) to the
2 taxpayer.

3 (B) Stock issued by a corporation shall not be treated as qualified
4 small business stock if, during the two-year period beginning on
5 the date one year before the issuance of the stock, the corporation
6 made one or more purchases of its stock with an aggregate value
7 (as of the time of the respective purchases) exceeding 5 percent
8 of the aggregate value of all of its stock as of the beginning of the
9 two-year period.

10 (C) If any transaction is treated under Section 304(a) of the
11 Internal Revenue Code as a distribution in redemption of the stock
12 of any corporation, for purposes of subparagraphs (A) and (B), the
13 corporation shall be treated as purchasing an amount of its stock
14 equal to the amount treated as a distribution in redemption of the
15 stock of the corporation under Section 304(a) of the Internal
16 Revenue Code.

17 (d) For purposes of this section:

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

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

25 (B) The aggregate gross assets of the corporation immediately
26 after the issuance (determined by taking into account amounts
27 received in the issuance) do not exceed fifty million dollars
28 (\$50,000,000).

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

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

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

38 (B) For purposes of subparagraph (A), the adjusted basis of any
39 property contributed to the corporation (or other property with a
40 basis determined in whole or in part by reference to the adjusted

1 basis of property so contributed) shall be determined as if the basis
2 of the property contributed to the corporation immediately after
3 the contribution was equal to its fair market value as of the time
4 of the contribution.

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

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

12 (i) “More than 50 percent” shall be substituted for “at least 80
13 percent” each place it appears in Section 1563(a)(1) of the Internal
14 Revenue Code.

15 (ii) Section 1563(a)(4) of the Internal Revenue Code shall not
16 apply.

17 (e) (1) For purposes of paragraph (2) of subdivision (c), the
18 requirements of this subdivision are met by a corporation for any
19 period if during that period both of the following apply:

20 (A) At least 80 percent (by value) of the assets of the corporation
21 are used by the corporation in the active conduct of one or more
22 qualified trades or businesses.

23 (B) The corporation is an eligible corporation.

24 (2) For purposes of paragraph (1), if, in connection with any
25 future qualified trade or business, a corporation is engaged in one
26 of the following:

27 (A) Startup activities described in Section 195(c)(1)(A) of the
28 Internal Revenue Code.

29 (B) Activities resulting in the payment or incurring of
30 expenditures which may be treated as research and experimental
31 expenditures under Section 174 of the Internal Revenue Code.

32 (C) Activities with respect to in-house research expenses
33 described in Section 41(b)(4) of the Internal Revenue Code, then
34 assets used in those activities shall be treated as used in the active
35 conduct of a qualified trade or business. Any determination under
36 this paragraph shall be made without regard to whether a
37 corporation has any gross income from those activities at the time
38 of the determination.

1 (3) For purposes of this subdivision, the term “qualified trade
2 or business” means any trade or business other than any of the
3 following:

4 (A) Any trade or business involving the performance of services
5 in the fields of health, law, engineering, architecture, accounting,
6 actuarial science, performing arts, consulting, athletics, financial
7 services, brokerage services, or any trade or business where the
8 principal asset of the trade or business is the reputation or skill of
9 one or more of its employees.

10 (B) Any banking, insurance, financing, leasing, investing, or
11 similar business.

12 (C) Any farming business (including the business of raising or
13 harvesting trees).

14 (D) Any business involving the production or extraction of
15 products of a character with respect to which a deduction is
16 allowable under Section 613 or 613A of the Internal Revenue
17 Code.

18 (E) Any business of operating a hotel, motel, restaurant, or
19 similar business.

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

23 (A) A DISC or former DISC.

24 (B) A corporation with respect to which an election under
25 Section 936 of the Internal Revenue Code is in effect or which has
26 a direct or indirect subsidiary with respect to which the election
27 is in effect.

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

30 (D) A cooperative.

31 (5) (A) For purposes of this subdivision, stock and debt in any
32 subsidiary corporation shall be disregarded and the parent
33 corporation shall be deemed to own its ratable share of the
34 subsidiary’s assets, and to conduct its ratable share of the
35 subsidiary’s activities.

36 (B) A corporation shall be treated as failing to meet the
37 requirements of paragraph (1) for any period during which more
38 than 10 percent of the value of its assets (in excess of liabilities)
39 consists of stock or securities in other corporations which are not

1 subsidiaries of the corporation (other than assets described in
2 paragraph (6)).

3 (C) For purposes of this paragraph, a corporation shall be
4 considered a subsidiary if the parent owns more than 50 percent
5 of the combined voting power of all classes of stock entitled to
6 vote, or more than 50 percent in value of all outstanding stock, of
7 the corporation.

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

11 (A) Assets that are held as a part of the reasonably required
12 working capital needs of a qualified trade or business of the
13 corporation.

14 (B) Assets that are held for investment and are reasonably
15 expected to be used within two years to finance research and
16 experimentation in a qualified trade or business or increases in
17 working capital needs of a qualified trade or business. For periods
18 after the corporation has been in existence for at least two years,
19 in no event may more than 50 percent of the assets of the
20 corporation qualify as used in the active conduct of a qualified
21 trade or business by reason of this paragraph.

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

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

34 (f) If any stock in a corporation is acquired solely through the
35 conversion of other stock in the corporation that is qualified small
36 business stock in the hands of the taxpayer, both of the following
37 shall apply:

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

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

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

6 (A) The amount shall be treated as gain described in subdivision
7 (a).

8 (B) For purposes of applying subdivision (b), the amount shall
9 be treated as gain from a disposition of stock in the corporation
10 issuing the stock disposed of by the pass-thru entity and the
11 taxpayer's proportionate share of the adjusted basis of the pass-thru
12 entity in the stock shall be taken into account.

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

15 (A) The amount is attributable to gain on the sale or exchange
16 by the pass-thru entity of stock that is qualified small business
17 stock in the hands of the entity (determined by treating the entity
18 as an individual) and that was held by that entity for more than
19 five years.

20 (B) The amount is includable in the gross income of the taxpayer
21 by reason of the holding of an interest in the entity that was held
22 by the taxpayer on the date on which the pass-thru entity acquired
23 the stock and at all times thereafter before the disposition of the
24 stock by the pass-thru entity.

25 (3) Paragraph (1) shall not apply to any amount to the extent
26 the amount exceeds the amount to which paragraph (1) would have
27 applied if the amount was determined by reference to the interest
28 the taxpayer held in the pass-thru entity on the date the qualified
29 small business stock was acquired.

30 (4) For purposes of this subdivision, the term "pass-thru entity"
31 means any of the following:

32 (A) Any partnership.

33 (B) Any "S" corporation.

34 (C) Any regulated investment company.

35 (D) Any common trust fund.

36 (h) For purposes of this section:

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

39 (A) Having acquired the stock in the same manner as the
40 transferor.

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

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

6 (A) By gift.

7 (B) At death.

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

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

14 (4) (A) In the case of a transaction described in Section 351 of
15 the Internal Revenue Code or a reorganization described in Section
16 368 of the Internal Revenue Code, if qualified small business stock
17 is exchanged for other stock that would not qualify as qualified
18 small business stock but for this subparagraph, the other stock
19 shall be treated as qualified small business stock acquired on the
20 date on which the exchanged stock was acquired.

21 (B) This section shall apply to gain from the sale or exchange
22 of stock treated as qualified small business stock by reason of
23 subparagraph (A) only to the extent of the gain that would have
24 been recognized at the time of the transfer described in
25 subparagraph (A) if Section 351 or 368 of the Internal Revenue
26 Code had not applied at that time. The preceding sentence shall
27 not apply if the stock that is treated as qualified small business
28 stock by reason of subparagraph (A) is issued by a corporation
29 that (as of the time of the transfer described in subparagraph (A))
30 is a qualified small business.

31 (C) For purposes of this paragraph, stock treated as qualified
32 small business stock under subparagraph (A) shall be so treated
33 for subsequent transactions or reorganizations, except that the
34 limitation of subparagraph (B) shall be applied as of the time of
35 the first transfer to which the limitation applied (determined after
36 the application of the second sentence of subparagraph (B)).

37 (D) In the case of a transaction described in Section 351 of the
38 Internal Revenue Code, this paragraph shall apply only if
39 immediately after the transaction the corporation issuing the stock
40 owns directly or indirectly stock representing control (within the

1 meaning of Section 368(c) of the Internal Revenue Code) of the
2 corporation whose stock was exchanged.

3 (i) For purposes of this section:

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

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

9 (B) The basis of the stock in the hands of the taxpayer shall in
10 no event be less than the fair market value of the property
11 exchanged.

12 (2) If the adjusted basis of any qualified small business stock
13 is adjusted by reason of any contribution to capital after the date
14 on which the stock was originally issued, in determining the
15 amount of the adjustment by reason of the contribution, the basis
16 of the contributed property shall in no event be treated as less than
17 its fair market value on the date of the contribution.

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

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

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

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

29 (A) The taxpayer has made a short sale of substantially identical
30 property.

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

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

1 (k) The Franchise Tax Board may prescribe those regulations
2 as may be appropriate to carry out the purposes of this section,
3 including regulations to prevent the avoidance of the purposes of
4 this section through split-ups, shell corporations, partnerships, or
5 otherwise.

6 (l) It is the intent of the Legislature that, in construing this
7 section, any regulations that may be promulgated by the Secretary
8 of the Treasury under Section 1202(k) of the Internal Revenue
9 Code shall apply to the extent that those regulations do not conflict
10 with this section or with any regulations that may be promulgated
11 by the Franchise Tax Board.

12 (m) This section shall apply to sales, including installment sales,
13 occurring in taxable years beginning on or after January 1, 2015.

14 SEC. 5. This act provides for a tax levy within the meaning of
15 Article IV of the Constitution and shall go into immediate effect.