

AMENDED IN ASSEMBLY APRIL 12, 2000

CALIFORNIA LEGISLATURE—1999–2000 REGULAR SESSION

ASSEMBLY BILL

No. 1783

Introduced by Assembly Members Nakano and Correa
(Principal coauthor: Assembly Member Cunneen)
(Coauthors: Assembly Members Alquist, Baugh, Briggs,
Calderon, Cox, Florez, Leach, Lempert, Mazzoni, Papan,
Runner, Strickland, and Zettel)
(Coauthor: Senator Poochigian)

January 25, 2000

An act to amend Section 18152.5 of the Revenue and Taxation Code, relating to taxation, to take effect immediately, tax levy.

LEGISLATIVE COUNSEL'S DIGEST

AB 1783, as amended, Nakano. Personal income taxes: qualified small business stock.

The Personal Income Tax Law provides 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, that was acquired at its original issuance on or after August 10, 1993.

This bill would provide that gross income does not include any gain from the sale or exchange of qualified small business stock purchased after the effective date of the bill and held for more than 5 years.

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 18152.5 of the Revenue and
2 Taxation Code is amended to read:
3 18152.5. (a) (1) ~~For~~ *Except as provided in*
4 *paragraph (2), for purposes of this part, gross income shall*
5 *not include 50 percent of any gain from the sale or*
6 *exchange of qualified small business stock purchased*
7 ~~prior to the effective date of the amendments to this~~
8 ~~section made in 2000, and held for more than five~~ *held for*
9 *more than five years.*
10 ~~(2) For purposes of this part, gross income shall not~~
11 ~~include, any gain from the sale or exchange of qualified~~
12 ~~small business stock purchased after the effective day of~~
13 ~~the amendments to this section made in 2000, and held for~~
14 *(2) In the case of any qualified small business stock*
15 *described in paragraph (2) of subdivision (c), gross*
16 *income shall not include any gain from the sale or*
17 *exchange of qualified small business stock described in*
18 *paragraph (2) of subdivision (c) held for more than five*
19 *years.*
20 (b) (1) If the taxpayer has eligible gain for the taxable
21 year from one or more dispositions of stock issued by any
22 corporation, the aggregate amount of the gain from
23 dispositions of stock issued by the corporation which may
24 be taken into account under subdivision (a) for the
25 taxable year shall not exceed the greater of either of the
26 following:
27 (A) Ten million dollars (\$10,000,000) reduced by the
28 aggregate amount of eligible gain taken into account by
29 the taxpayer under subdivision (a) for prior taxable years
30 and attributable to dispositions of stock issued by the
31 corporation.
32 (B) Ten times the aggregate adjusted bases of
33 qualified small business stock issued by the corporation
34 and disposed of by the taxpayer during the taxable year.
35 For purposes of subparagraph (B), the adjusted basis of



1 any stock shall be determined without regard to any
2 addition to basis after the date on which the stock was
3 originally issued.

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

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

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

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

20 (c) For purposes of this section:

21 (1) Except as otherwise provided in this section, the
22 term “qualified small business stock” means any stock in
23 a C corporation which is originally issued after August 10,
24 1993, *and before the effective date of the amendments*
25 *made to this section in 2000*, if both of the following apply:

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

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

32 (i) In exchange for money or other property (not
33 including stock).

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

37 (2) *Except as otherwise provided in this section, the*
38 *term “qualified small business stock” means any stock in*
39 *a C corporation which is originally issued on or after the*



1 *effective date of the amendments made to this section in*
2 *2000, if both of the following apply:*

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

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

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

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

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

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

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

30 ~~(3)~~

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

39 (B) Stock issued by a corporation shall not be treated
40 as qualified small business stock if, during the two-year



1 period beginning on the date one year before the issuance
2 of the stock, the corporation made one or more purchases
3 of its stock with an aggregate value (as of the time of the
4 respective purchases) exceeding 5 percent of the
5 aggregate value of all of its stock as of the beginning of the
6 two-year period.

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

15 (d) For purposes of this section:

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

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

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

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

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

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

39 (B) For purposes of subparagraph (A), the adjusted
40 basis of any property contributed to the corporation (or



1 other property with a basis determined in whole or in part
2 by reference to the adjusted basis of property so
3 contributed) shall be determined as if the basis of the
4 property contributed to the corporation immediately
5 after the contribution was equal to its fair market value
6 as of the time of the contribution.

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

10 (B) For purposes of subparagraph (A), the term
11 “parent-subsiary controlled group” means any
12 controlled group of corporations as defined in Section
13 1563(a)(1) of the Internal Revenue Code, except that
14 both of the following shall apply:

15 (i) “More than 50 percent” shall be substituted for “at
16 least 80 percent” each place it appears in Section
17 1563(a)(1) of the Internal Revenue Code.

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

20 (e) (1) For purposes of ~~paragraph (2)~~ *paragraph (3)*
21 of subdivision (c), the requirements of this subdivision
22 are met by a corporation for any period if during that
23 period both of the following apply:

24 (A) At least 80 percent (by value) of the assets of the
25 corporation are used by the corporation in the active
26 conduct of one or more qualified trades or businesses in
27 California.

28 (B) The corporation is an eligible corporation.

29 (2) For purposes of paragraph (1), if, in connection
30 with any future qualified trade or business, a corporation
31 is engaged in:

32 (A) Startup activities described in Section
33 195(c)(1)(A) of the Internal Revenue Code,

34 (B) Activities resulting in the payment or incurring of
35 expenditures which may be treated as research and
36 experimental expenditures under Section 174 of the
37 Internal Revenue Code, or

38 (C) Activities with respect to in-house research
39 expenses described in Section 41(b)(4) of the Internal
40 Revenue Code, then assets used in those activities shall be



1 treated as used in the active conduct of a qualified trade
2 or business. Any determination under this paragraph
3 shall be made without regard to whether a corporation
4 has any gross income from those activities at the time of
5 the determination.

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

9 (A) Any trade or business involving the performance
10 of services in the fields of health, law, engineering,
11 architecture, accounting, actuarial science, performing
12 arts, consulting, athletics, financial services, brokerage
13 services, or any trade or business where the principal
14 asset of the trade or business is the reputation or skill of
15 one or more of its employees.

16 (B) Any banking, insurance, financing, leasing,
17 investing, or similar business.

18 (C) Any farming business (including the business of
19 raising or harvesting trees).

20 (D) Any business involving the production or
21 extraction of products of a character with respect to
22 which a deduction is allowable under Section 613 or 613A
23 of the Internal Revenue Code.

24 (E) Any business of operating a hotel, motel,
25 restaurant, or similar business.

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

29 (A) A DISC or former DISC.

30 (B) A corporation with respect to which an election
31 under Section 936 of the Internal Revenue Code is in
32 effect or which has a direct or indirect subsidiary with
33 respect to which the election is in effect.

34 (C) A regulated investment company, real estate
35 investment trust (REIT), or real estate mortgage
36 investment conduit (REMIC).

37 (D) A cooperative.

38 (5) (A) For purposes of this subdivision, stock and
39 debt in any subsidiary corporation shall be disregarded
40 and the parent corporation shall be deemed to own its



1 ratable share of the subsidiary's assets, and to conduct its
2 ratable share of the subsidiary's activities.

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

9 (C) For purposes of this paragraph, a corporation shall
10 be considered a subsidiary if the parent owns more than
11 50 percent of the combined voting power of all classes of
12 stock entitled to vote, or more than 50 percent in value
13 of all outstanding stock, of the corporation.

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

17 (A) Assets that are held as a part of the reasonably
18 required working capital needs of a qualified trade or
19 business of the corporation.

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

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

37 (8) For purposes of paragraph (1), rights to computer
38 software that ~~—produces~~ *produce* active business
39 computer software royalties (within the meaning of
40 Section 543(d)(1) of the Internal Revenue Code) shall be



1 treated as an asset used in the active conduct of a trade
2 or business.

3 (9) A corporation shall not be treated as meeting the
4 requirements of paragraph (1) for any period during
5 which more than 20 percent of the corporation's total
6 payroll expense is attributable to employment located
7 outside of California.

8 (f) If any stock in a corporation is acquired solely
9 through the conversion of other stock in the corporation
10 that is qualified small business stock in the hands of the
11 taxpayer, ~~both~~ all of the following shall apply:

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

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

17 (3) *The stock so acquired shall be treated as having
18 been originally issued on the date on which the converted
19 stock was originally issued for purposes of determining
20 whether paragraph (1) or paragraph (2) of subdivision
21 (a) applies to any subsequent sale or exchange of that
22 stock.*

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

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

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

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

37 (A) The amount is attributable to gain on the sale or
38 exchange by the pass-through entity of stock that is
39 qualified small business stock in the hands of the entity



1 (determined by treating the entity as an individual) and
2 that was held by that entity for more than five years.

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

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

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

- 17 (A) Any partnership.
- 18 (B) Any S corporation.
- 19 (C) Any regulated investment company.
- 20 (D) Any common trust fund.

21 (h) For purposes of this section:

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

25 (A) Having acquired the stock in the same manner
26 *and on the same date* as the transferor.

27 (B) Having held the stock during any continuous
28 period immediately preceding the transfer during which
29 it was held (or treated as held under this subdivision) by
30 the transferor.

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

- 33 (A) By gift.
- 34 (B) At death.

35 (C) From a partnership to a partner of stock with
36 respect to which requirements similar to the
37 requirements of subdivision (g) are met at the time of the
38 transfer (without regard to the five-year holding period
39 requirement).



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

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

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

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

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

39 (E) *For purposes of applying this subparagraph, the*
40 *following additional rules shall apply to transactions and*



1 reorganizations described in subparagraph (A) that
2 occur on or after the effective date of the amendments
3 made to this section in 2000.

4 (i) In the case of any qualified small business stock that
5 would have qualified for the 50 percent exclusion under
6 paragraph (1) of subdivision (a) if sold or exchanged in
7 a transaction in which gain was recognized that is instead
8 exchanged in a transaction or reorganization described in
9 subparagraph (A), the second sentence of subparagraph
10 (B) shall be applied by treating any qualified small
11 business stock received in the exchange, whether that
12 stock would qualify for the 50 percent exclusion under
13 paragraph (1) of subdivision (a) or the 100 percent
14 exclusion under paragraph (2) of subdivision (a), as
15 qualified small business stock eligible for the 50 percent
16 exclusion under paragraph (1) of subdivision (a).

17 (ii) In the case of any qualified small business stock
18 that would have qualified for the 100 percent exclusion
19 under paragraph (2) of subdivision (a) if sold or
20 exchanged in a transaction in which gain was recognized
21 that is instead exchanged in a transaction or
22 reorganization described in subparagraph (A), the
23 second sentence of subparagraph (B) shall be applied by
24 treating any qualified small business stock received in the
25 exchange, whether that stock would qualify for the 50
26 percent exclusion under paragraph (1) of subdivision (a)
27 or the 100 percent exclusion under paragraph (2) of
28 subdivision (a), as qualified small business stock eligible
29 for the 100 percent exclusion under paragraph (2) of
30 subdivision (a).

31 (i) For purposes of this section:

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

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

38 (B) The basis of the stock in the hands of the taxpayer
39 shall in no event be less than the fair market value of the
40 property exchanged.



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

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

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

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

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

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

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

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

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

39 (l) It is the intent of the Legislature that, in construing
40 this section, any regulations that may be promulgated by



1 the Secretary of the Treasury under Section 1202(k) of
2 the Internal Revenue Code shall apply to the extent that
3 those regulations do not conflict with this section or with
4 any regulations that may be promulgated by the
5 Franchise Tax Board.

6 SEC. 2. This act provides for a tax levy within the
7 meaning of Article IV of the Constitution and shall go into
8 immediate effect.

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