

RECEIVED

APR 15 2013

REED SMITH LLP

LOS ANGELES

# Daily Journal

www.dailyjournal.com

VOL. 126 NO. 072

MONDAY, APRIL 15, 2013

© 2013 Daily Journal Corporation. All Rights Reserved

## Tax board's retroactive ruling irks startup investors, advisers

By Alexandra Schwappach  
Daily Journal Staff Writer

Small-business owners in California might be getting an unwanted surprise in their mailboxes this tax season — a bill for a tax deduction they took advantage of five years ago. Some experts say the tax further burdens the economy in a state well known for favoring and nurturing startups.

The state Franchise Tax Board, citing a court ruling, decided in December to eliminate a tax deduction for people who buy, sell or invest in startup companies — an incentive that had been in place

for almost 20 years. Now some small businesses are starting to bite back.

Since 1993, California has had its own version of a federal income tax law that provides for the exclusion or deferral of gain from the sale of qualified small business stock, known as QSBS. The state law required that at least 80 percent of the company's payroll and assets be within California.

In 2009, Orange County business owner Frank Cutler brought a suit against the tax board alleging that the tax break for California business owners was unfair because it prioritized in-state businesses



Hugh Williams/ Special to the Daily Journal

Marty Dakessian, a partner at Reed Smith LLP

See Page 6 — CHANGE

## Change in startup investment rule has some investors fuming

Continued from page 1

over others. He had tried to qualify for the exemption in 1998 but was denied because the company whose stock he sold did not maintain 80 percent of its payroll and property in the state.

In its August ruling, the 2nd District Court of Appeal held that the statute — specifically the portion requiring that at least 80 percent of the company's payroll and property be within California — violated the Commerce Clause of the Constitution because it discriminated against businesses outside the state. *Cutler v. The Franchise Tax Board of the State of California*, BC421864 (Cal. App. 2nd Dist., filed Aug. 28, 2012).

Following the court's decision, the tax board issued a notice that it would eliminate the tax deduction altogether and bill anyone who benefited from it since 2008.

Marty Dakessian, partner at Reed Smith LLP in Los Angeles, who represented Cutler, said it is important to note that the appellate opinion in *Cutler* did not in any way "mandate or authorize" the retroactive policy from the Franchise Tax Board.

"The Court of Appeal's decision was very narrow," he said. "They only opined on the California payroll and property requirements of the startup tax incentive. But the [Franchise Tax Board] took the position that the entire statute is invalid."

The retroactive tax stands to affect more than 2,000 taxpayers and will account for about \$130 million in tax breaks since 2008, according to a tax board spokes-

woman.

"It's very questionable what they've done, and it's just bad policy," Dakessian said. "It's becoming an issue of the business climate in California."

According to the Franchise Tax Board's website, after the appellate panel found the statute unconstitutional, the agency carefully considered every administrative option to honor the court's finding.

"We found no lawful option for the FTB but to strike the provisions for tax years within the statute of limitations," the agency said on its website. "The court found that the statute improperly discriminates against interstate commerce, which is a situation which must be remedied."

Mark A. Leahy, a partner at Fenwick & West LLP whose practice includes start-up counseling and venture capital financings, said the tax break elimination has venture capitalists moaning and groaning.

"It's extremely frustrating and disappointing that the state of California would discourage investment in companies in its own state," he said.

The tax board is asking taxpayers who took advantage of the tax break to file amended returns for the years in which the exclusions or deferrals were reported. Wendy Bleiman, of counsel at Jeffer Mangels Butler & Mitchell LLP in Los Angeles, represents clients in connection with state income tax matters and said taxpayers who relied on the California QSBS statute and do not file

amended returns should expect to be contacted by the Franchise Tax Board.

"Because every taxpayer's situation is unique, anyone who believes that they excluded or deferred gain under California's QSBS statute in any tax year beginning on or after January 1, 2008, should contact their tax adviser to more fully understand their options and determine what action is advisable with respect to their California income tax returns," she said.

"It's very questionable what they've done, and it's just bad policy."

— Marty Dakessian

However discouraging the tax board's decision may be, Leahy said he doesn't think it's enough to drive venture capitalists out of California. He said a tax break is a small part of what goes into an investor's decision to invest in a startup, or into a business owner's decision on where to base their operations.

"Certainly tax breaks are an important part of it," he said.

"But entrepreneurs also want access to engineers and other entrepreneurs. They also want access to Silicon Valley-type lawyers whose meat and potatoes are working with startups."

But some small-business owners around the state aren't planning on backing down. Dakessian said after the tax board posted its notice "in the dark of night" on Dec. 21, his office started receiving a lot of worried phone calls from clients. Since then, Dakessian and others have formed the California Coalition of Qualified Small Business Investors — a group pursuing "legislative and legal means to prevent the FTB from taking its aggressive position."

Taxpayers who took advantage of the QSBS statute in 2008 or later can expect to receive a notice of proposed assessment from the Franchise Tax Board. Dakessian said so far none of his clients have received assessments, but when they do they'll need to proactively protect their administrative rights. Lawsuits are likely to result, he said.

"No matter who it impacts, people understand that there's a certain level of offense that's taken any time the rules are changed in the middle of the game," Dakessian said. "To engage in sort of 'gotcha' tax administrations based on a distortion of a taxpayer win — that's grotesque."

alexandra\_schwappach@dailyjournal.com