SENATE, No. 4127

STATE OF NEW JERSEY

219th LEGISLATURE

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Sponsored by:
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District 24 (Morris, Sussex and Warren)
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SYNOPSIS

Allows deduction from New Jersey gross income of certain capital gains from sale or exchange of New Jersey qualified small business stock held for more than five years.

CURRENT VERSION OF TEXT

As introduced.

(Sponsorship Updated As Of: 12/20/2021)

AN ACT allowing a deduction from New Jersey gross income of certain capital gains from sale or exchange of New Jersey qualified small business stock held for more than five years, supplementing Title 54A of the New Jersey Statutes.

BE IT ENACTED *by the Senate and General Assembly of the State of New Jersey:*

1. a. Notwithstanding the provisions of N.J.S.54A:5-1, a taxpayer who is an individual shall be allowed to deduct from the taxpayer's gross income in a taxable year the eligible gain from the sale or exchange of New Jersey qualified small business stock held for more than five years.

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

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

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

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

(3) (a) In the case of a married individual filing a separate return, subparagraph (a) of paragraph (1) of this subsection shall be five million dollars ($5,000,000).

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

c. As used in this section:

(1) “Qualified small business stock” means any stock in a C corporation which is originally issued after the effective date of P.L. , c. (C.) (pending before the Legislature as this bill), if both of the following apply:

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

(b) Except as provided in subsections e. and g., the stock is acquired by the taxpayer at its original issue (directly or through an

underwriter) in either of the following manners:

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

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

(2) (a) Stock in a corporation shall not be treated as qualified small business stock unless, during substantially all of the taxpayer's holding period for the stock, the corporation meets the active business requirements of subsection d. of this section and the corporation is a C corporation.

(b) (i) Notwithstanding subsection d. of this section, a corporation shall be treated as meeting the active business requirements of subsection d. for any period during which the corporation qualifies as a specialized small business investment company.

(ii) For purposes of subsubparagraph (i) of this subparagraph, the term "specialized small business investment company" means any eligible corporation (as defined in paragraph (4) of subsection d. of this section) that is licensed to operate under Section 301(d) of the federal Small Business Investment Act of 1958 (as in effect on May 13, 1993).

(3) (a) Stock acquired by the taxpayer shall not be treated as qualified small business stock if, at any time during the four-year period beginning on the date two years before the issuance of the stock, the corporation issuing the stock purchased (directly or indirectly) any of its stock from the taxpayer or from a related person to the taxpayer. For the purposes of this subparagraph, "related person" means a corporation, partnership, association or trust controlled by the taxpayer; an individual, corporation, partnership, association or trust that is in the control of the taxpayer; a corporation, partnership, association or trust controlled by an individual, corporation, partnership, association or trust that is in the control of the taxpayer; or a member of the same controlled group as the taxpayer.

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

(c) If any transaction is treated under section 304(a) of the Internal Revenue Code (26 U.S.C. s.304(a)) as a distribution in redemption of the stock of any corporation, for purposes of subparagraphs (a) and (b), the corporation shall be treated as purchasing an amount of its stock equal to the amount treated as a distribution in redemption of the stock of the corporation under section 304(a) of the Internal Revenue Code (26 U.S.C. s.304(a)).

(4) "Qualified small business" means any domestic corporation (as defined in section 7701(a)(4) of the Internal Revenue Code (26 U.S.C. s.7701(a)(4))) which is a C corporation, if all of the following apply:

(a) The aggregate gross assets of the corporation (or any predecessor thereof) at all times on or after the effective date of P.L. , c. (C.) (pending before the Legislature as this bill), and before the issuance did not exceed $50,000,000;

(b) The aggregate gross assets of the corporation immediately after the issuance (determined by taking into account amounts received in the issuance) do not exceed $50,000,000, where "aggregate gross assets" mean the amount of cash and the aggregate adjusted basis of other property held by the corporation, but the adjusted basis of any property contributed to the corporation (or other property with a basis determined in whole or in part by reference to the adjusted basis of property so contributed) shall be determined as if the basis of the property contributed to the corporation immediately after the contribution was equal to its fair market value as of the time of the contribution; and

(c) Has fewer than 225 employees and at least 80 percent of the corporation's payroll, as measured by total dollar value, is attributable to employment located within this State.

Provided, however, that all corporations which are members of the same parent-subsidiary controlled group shall be treated as one corporation for purposes of this subsection, where "parent-subsidiary controlled group" means any controlled group of corporations as defined in section 1563(a)(1) of the Internal Revenue Code (26 U.S.C. s.1563(a)(1)), except that that percentages of ownership and value that control shall exist in situations involving at least 50 percent of ownership and value as otherwise provided involving at least 80 percent required by section 1563(a)(1) (26 U.S.C. s.1563(a)(1)), and section 1563(a)(4) of the Internal Revenue Code (26 U.S.C. s.1563(a)(4)) shall not apply.

d. (1) The active business requirements of paragraph (2) of subsection c. shall be met by a corporation for any period if during that period:

(a) At least 80 percent (by value) of the assets of the corporation are used by the corporation in the active conduct of one or more qualified trades or businesses; and

(b) The corporation is a domestic corporation, but shall not include any of the following: (i) a domestic international sales corporation (DISC) or former DISC; (ii) A corporation with respect to which an election under section 936 of the Internal Revenue Code (26 U.S.C. s.936) is in effect or which has a direct or indirect subsidiary with respect to which the election is in effect; (iii) A regulated investment company, real estate investment trust (REIT), or real estate mortgage investment conduit (REMIC); or (iv) A cooperative.

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

(a) Startup activities described in section 195(c)(1)(A) of the Internal Revenue Code (26 U.S.C. s.195(c)(1)(A)),

(b) Activities resulting in the payment or incurring of expenditures which may be treated as research and experimental expenditures under section 174 of the Internal Revenue Code (26 U.S.C. s.174), or

(c) Activities with respect to in-house research expenses described in section 41(b)(4) of the Internal Revenue Code (26 U.S.C. s.41(b)(4)), then assets used in those activities shall be treated as used in the active conduct of a qualified trade or business. Any determination under this paragraph (1) shall be made without regard to whether a corporation has any gross income from those activities at the time of the determination.

(3) For purposes of this subsection d., "qualified trade or business" means any trade or business other than any of the following:

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

(b) Any banking, insurance, financing, leasing, investing, or similar business.

(c) Any farming business (including the business of raising or harvesting trees).

(d) Any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A of the Internal Revenue Code (26 U.S.C. s.613 or s.613A).

(e) Any business of operating a hotel, motel, restaurant, or similar business.

(4) (a) For purposes of this subsection d., stock and debt in any subsidiary corporation shall be disregarded and the parent corporation shall be deemed to own its ratable share of the subsidiary's assets, and to conduct its ratable share of the subsidiary's activities.

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

(c) For purposes of this paragraph (4), a corporation shall be considered a subsidiary if the parent owns more than 50 percent of the combined voting power of all classes of stock entitled to vote,

or more than 50 percent in value of all outstanding stock, of the corporation.

(5) For purposes of subparagraph (a) of paragraph (1) of this subsection d., the following assets shall be treated as used in the active conduct of a qualified trade or business:

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

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

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

(7) For purposes of paragraph (1) of this subsection, rights to computer software that produces active business computer software royalties (within the meaning of section 543(d)(1) of the Internal Revenue Code (26 U.S.C. s.543(d)(1))) shall be treated as an asset used in the active conduct of a trade or business.

e. If any stock in a corporation is acquired solely through the conversion of other stock in the corporation that is qualified small business stock in the hands of the taxpayer, the stock so acquired shall be treated as qualified small business stock in the hands of the taxpayer and the stock so acquired shall be treated as having been held during the period during which the converted stock was held.

f. (1) If any amount included in gross income by reason of holding an interest in a pass-through entity meets the requirements of paragraph (2) of this subsection f., the following shall apply:

(a) The amount shall be treated as gain described in subsection a. of this section; and

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

(2) An amount shall meet the requirements of paragraph (1) of this subsection f. if:

(a) The amount is attributable to gain on the sale or exchange by the pass-through entity of stock that is qualified small business

stock in the hands of the entity (determined by treating the entity as an individual) and that was held by that entity for more than five years; and

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

Provided however, that paragraph (1) of this subsection f. shall not apply to any amount to the extent the amount exceeds the amount to which that paragraph (1) would have applied if the amount was determined by reference to the interest the taxpayer held in the pass-through entity on the date the qualified small business stock was acquired. Provided further, that "pass-through entity" means any of the following: a partnership; an S corporation; a regulated investment company; or a common trust fund.

g. For purposes of this section:

(1) In the case of a transfer described in paragraph (2) of this subsection, the transferee shall be treated as meeting both: having acquired the stock in the same manner as the transferor; and having held the stock during any continuous period immediately preceding the transfer during which it was held (or treated as held under this subdivision) by the transferor.

(2) A transfer is described in this subsection if the transfer is any of the following:

(a) By gift.

(b) At death.

(c) From a partnership to a partner of stock with respect to which requirements similar to the requirements of subsection f. of this section are met at the time of the transfer (without regard to the five-year holding period requirement).

(3) Rules similar to the rules of section 1244(d)(2) of the Internal Revenue Code (26 U.S.C. s.1244(d)(2)) shall apply for purposes of this section.

(4) (a) In the case of a transaction described in section 351 of the Internal Revenue Code (26 U.S.C. s.351) or a reorganization described in section 368 of the Internal Revenue Code (26 U.S.C. s.368), if qualified small business stock is exchanged for other stock that would not qualify as qualified small business stock but for this paragraph (4), the other stock shall be treated as qualified small business stock acquired on the date on which the exchanged stock was acquired.

(b) This subsection e. shall apply to gain from the sale or exchange of stock treated as qualified small business stock by reason of subparagraph (a) of this paragraph only to the extent of the gain that would have been recognized at the time of the transfer described in subparagraph (a) of this paragraph if section 351 or 368 of the Internal Revenue Code (26 U.S.C. s.351 or s.368) had

not applied at that time. The preceding sentence shall not apply if the stock that is treated as qualified small business stock by reason of subparagraph (a) of this paragraph is issued by a corporation that (as of the time of the transfer described in that subparagraph (a)) is a qualified small business.

(c) For purposes of this paragraph (4), stock treated as qualified small business stock under subparagraph (a) shall be so treated for subsequent transactions or reorganizations, except that the limitation of subparagraph (b) shall be applied as of the time of the first transfer to which the limitation applied (determined after the application of the second sentence of subparagraph (b)).

(d) In the case of a transaction described in section 351 of the Internal Revenue Code (26 U.S.C. s.351), this paragraph shall apply only if immediately after the transaction the corporation issuing the stock owns directly or indirectly stock representing control (within the meaning of section 368(c) of the Internal Revenue Code (26 U.S.C. s.368)) of the corporation whose stock was exchanged.

h. For purposes of this section:

(1) In the case in which the taxpayer transfers property (other than money or stock) to a corporation in exchange for stock in the corporation, the stock shall be treated as having been acquired by the taxpayer on the date of the exchange and the basis of the stock in the hands of the taxpayer shall in no event be less than the fair market value of the property exchanged.

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

i. (1) If the taxpayer has an offsetting short position with respect to any qualified small business stock, subsection a. shall not apply to any gain from the sale or exchange of the stock unless the stock was held by the taxpayer for more than five years as of the first day on which there was such a short position and the taxpayer elects to recognize gain as if the stock was sold on that first day for its fair market value.

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

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

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

(c) To the extent provided in regulations, the taxpayer has entered into any other transaction that substantially reduces the risk of loss from holding the qualified small business stock. For

purposes of the preceding sentence, any reference to the taxpayer shall be treated as including a reference to any person who is related (within the meaning of section 267(b) or 707(b) of the Internal Revenue Code (26 U.S.C. s.267(b) or s.707(b))) to the taxpayer.

j. A corporation that issues qualified small business stock agrees to submit reports to the Director of the Division of Taxation in the Department of the Treasury and to its shareholders as the director may require to carry out the purposes of this section.

2. The Director of the Division of Taxation in the Department of the Treasury shall prescribe regulations pursuant to the provision of the "Administrative Procedure Act," P.L.1968, c.410 (C.52:14B-1 et seq.) as may be appropriate to carry out the purposes of this act, including any regulations that may conform to those regulations promulgated by the Secretary of the Treasury under section 1202(k) of the Internal Revenue Code (26 U.S.C. s.1202(k)) that shall apply to the extent that those regulations do not conflict with this act, and such further regulation that shall include but be not limited to regulations to prevent the avoidance of the purposes of this act through splitups, shell corporations, partnerships, or otherwise.

3. This act shall take effect immediately.

STATEMENT

This bill allows for a deduction from New Jersey gross income of capital gains from the sale or exchange of New Jersey qualified small business stock held for more than five years. The deduction for these capital gains is modeled on the federal Internal Revenue Code capital gains exclusion for owners of Qualified Small Business Stock (QSBS) under section 1202 of the federal Internal Revenue Code.

For individual taxpayer/investors to qualify for the special capital gains treatment under section 1202 and this New Jersey gross income tax deduction, the stock must be in a domestic C corporation (not an S corporation or LLC), and it must be a C corporation during substantially all the time the individual holds the stock. The C corporation may not have more than $50 million in assets as of the date the stock was issued and immediately thereafter. The individual taxpayer/investor must acquire the stock at its original issue and not from a secondary market. Moreover, during substantially all the time the stock is held, at least 80 percent of the value of the corporation’s assets must be used in the active conduct of one or more qualified businesses. Active conduct of one or more qualified businesses cannot be an investment vehicle or inactive business. As under section 1202, the New Jersey gross income tax deduction of capital gains of the sale or exchange of

QSBS cannot be stock in a business that is: a service business in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services; a banking, insurance, financing, leasing, investing, or similar business; a farming business; a business of operating a hotel, motel, restaurant, or similar business.

If the individual taxpayer/investor holds qualifying stock for at least five years, then the individual taxpayer/investor would be able to exclude the capital gains made on the disposition of the stock, and thus pay no gross income on the capital gains. The special exclusion of capital gains for qualified stock that is held by "pass through entities," that include a partnership, an "S" corporation, a regulated investment company, or a common trust fund, that otherwise meet the requirements of this bill, is available to the individual gross income taxpayers who hold interests in those pass-through entities. The bill limits the aggregate amount of excludable capital gains for a taxable year, in the case of one or more dispositions of QSBS by a taxpayer, to the greater of $10 million, reduced by the aggregate amount of eligible gain taken into account by the taxpayer for prior taxable years and attributable to dispositions of QSBS, or ten times the aggregate adjusted basis of QSBS issued by the corporation and disposed of by the taxpayer during the taxable year. The QSBS must have been acquired in exchange for money or property, or as compensation for services provided to the corporation. At least 80 percent of the corporation's payroll, as measured by total dollar value, must be attributable to employment located within New Jersey.