Don't Mess With California: Why Proposition 23 Is Harmful

By Jennifer K. Berg

There is a scene in the Enron documentary *"The Smartest Guy in the Room,"* where two young Enron traders are heard on tape in their Texas offices speaking to each other on the telephone, while news footage plays scenes of out of control fires. One is sharing the news of soaring wildfires in California. The two are laughing and congratulating themselves on all of the money they will make due to the resultant high price of energy. One exclaims: "Burn, baby, burn" while the other responds: "That's a beautiful thing!" This scene is again being played through Proposition 23, an initiative on the November ballot funded by Texas oil companies who seek to protect their financial profit at the expense of the health and welfare of Californians. We should fight against these out of state interests and vote no on Proposition 23.

A little background: In 2006, the Legislature, with bi-partisan support, enacted the Global Warming Solutions Act (AB 32), which implements reductions in greenhouse gas emissions after recognizing that "[g]lobal warming poses a serious health threat to the economic well-being, public health, natural resources, and the environment of California..." Health and Safety Code Section 38501(a). (See *Communities for a Better Environment v. City of Richmond* (April 26, 2010) 184 Cal.App.4th 70.) Specifically, AB 32 is aimed at reducing California's emissions of carbon dioxide and other greenhouse gases to 1990 levels by 2020 and by 80 percent at midcentury. To reach these targets, state agencies are drawing up regulations requiring cleaner cars, more energy-efficient buildings, appliances, and power plants. AB 32 has been touted nationally and internationally as a model for effective action to help combat climate change. As businesses seek to comply with AB 32, California has seen the creation of 500,000 jobs and the addition of more than 12,000 businesses; $3 billion in venture capital has also been pumped into this state in the renewable energy industry, which is developing clean, efficient alternatives to fossil fuels. In the four years since California's clean air standards were passed, clean energy investment has tripled. About three of every five venture capital dollars nationwide has been invested in California companies, with about $2.1 billion worth of clean energy investments in 2009 alone, an amount that is expected to rise as the legislation goes into effect.

Proposition 23, if passed, would delay the implementation of AB 32 until the state unemployment rate falls below 5.5 percent for four quarters — something that has only happened three times in the last 40 years. Proposition 23 is an effort by out-of-state oil companies to place their financial interests over the welfare of this state's citizens, as was done during the Enron era. Delaying implementation of AB 32 would kill the burgeoning local clean tech industry, halt the influx of venture capital investment to these companies, maintain our dependence on foreign oil and jeopardize public health by increased air pollution and water contamination; disastrous consequences all in the name of protecting the pocket books of already wealthy oil interests.

Who is behind Proposition 23? Of the $8.2 million raised to support the proposition, $7.9 million is from out of state companies. Texas oil companies such as Valero and Tesoro are the primary funders. Koch Industries Inc. is also a major backer. According to an August 2010 article in *The New Yorker*, a recently released study by the Political Economy Research Institute at the University of Massachusetts at Amherst named Koch Industries one of the top 10 air polluters in the United States. Greenpeace also issued a report identifying the company as a "kingpin of climate science denial." The report showed that from 2005 to 2008, Koch Industries' vastly outdid ExxonMobil in giving money to organizations fighting legislation related to climate change.

This is not the time to debate climate change. As John McCain said in a May 2008 speech: "We have many advantages in the fight against global warming, but time is not one of them. Instead of idly debating the precise extent of global warming, or the precise timeline of global warming, we need to deal with...all the endless trouble that global warming will bring. We stand warned by serious and credible scientists across the world that time is short and the dangers are great." Indeed, there has been increased judicial recognition of climate change.

For example, Justice John Paul Stevens, writing for the majority in the case of *Massachusetts v. EPA* 127 S.Ct. 1438 (2007), wrote: "A well-documented rise in global temperatures has coincided with a significant increase in the concentration of carbon dioxide in the atmosphere. Respected scientists believe the two trends are related."

Climate change is not a Republican or Democratic issue. Climate change is truly color blind; it does not discriminate. All of us will suffer the harmful consequences of environmental degradation regardless of race, political party or social status. We should not let out of state oil interests derail our efforts to protect the welfare of California's citizens in an effort to maintain their shareholder value. As George Schultz, co-chair of "No on Prop. 23" campaign so eloquently wrote in a recent opinion piece in the *Sacramento Bee*: "California stands ready to once again lead. It's about preserving clean air for our kids and fostering good jobs for our workers. It's about a California that leads the world in the next great global industry and in facing the next great global challenge. The effort to derail it would be a tragic mistake."

Proposition 23 is a lose-lose-lose for the state — it would undermine our clean energy economy, increase air pollution, and drive up energy costs for businesses and families. Californians should join AARP, the American Lung Association in California, and other organizations in just saying no to the Texas oil companies' deceptive, greedy attempt to repeal our state's clean energy efforts. Let your no vote send a message to out of state interests: Don't mess with California!

Jennifer Karyn Berg is a proud born and bred Californian, who has represented plaintiffs in catastrophic injury and toxic tort cases in courts throughout the state. She recently obtained an executive certificate in sustainable management. She practices in Oakland.

Daily Journal

Charles T. Munger, Chairman of the Board
J.P. Guerin, Vice Chairman of the Board
Gerald L. Salzman, Publisher / Editor-in-Chief
Robert E. Work, Publisher (1950-1986)

David Houston, Editor

Alexia Garamfalvi, San Francisco Editor
Sharon Liang, Legal Editor

Liz Enochs, Associate Editor, *San Francisco*
Pia Sarkar, Associate Editor, *San Francisco*
Evan George, Associate Editor, *Los Angeles*
Michael Gottlieb, Associate Editor, *Los Angeles*

Richard Barkinskiy, Aris Davoudian, *Designers*

Los Angeles Staff Writers
Pat Alston, Richie Duchon, Gabe Friedman, Emma Gallegos, Kari Hamanaka, Catherine Ho,Ciaran McEvoy, Susan McRae, Brandon Ortiz, Jean-Luc Renault, Anna Scott

San Francisco Staff Writers
Rebecca Beyer, Laura Ernde, Sara Randazzo, Jill Redhage, John Roemer, Fiona Smith, Amy Yarbrough

Bureau Staff Writers
Emily Green, *Sacramento*, Craig Anderson, *San Jose*, Jason W. Armstrong, *Riverside*, Don J. DeBenedictis, *Santa Ana*, Pat Broderick, Mandy Jackson, *San Diego*, Lawrence Hurley, *Washington D.C.*

Robert Levins, S. Todd Rogers, *Photographers*
Lisa Kestenbaum, Carla Pineda *Editorial Assistants*

Rulings Service
Seena Nikravan, *Rulings Editor*
Meryl Chambers, *Verdicts and Settlements Editor*
Karen Natividad, Genevieve Knolle *Legal Writers*

Advertising
Audrey L. Miller, *Corporate Display Advertising Director*
Monica Smith, *Los Angeles Account Manager*
Joel Hale, Michelle Kenyon, *San Francisco Account Managers*
Kari Santos, *Display Advertising Coordinator*
Audrey Wood, *San Francisco Administrative Coordinator*

Art Department
Kathy Cullen, *Art Director*

The Daily Journal is a member of the Newspaper Association of America, California Newspaper Publishers Association, National Newspaper Association and Associated Press

An Investment Window for Qualified Small Business Stock

By David O. Kahn and Mimi Z. Chao

In an effort to help spur an economic recovery, Uncle Sam is offering a tax incentive for investing in innovative small businesses — but only to those who act promptly, as the window for taking advantage of a key capital gains provision of recently-enacted legislation will close at the end of 2010.

On Sept. 27, President Barack Obama signed the Small Business Jobs and Credit Act of 2010 into law. The legislation includes various tax incentives relating to small business growth, including a provision to permit the temporary exclusion of up to 100 percent of any gain realized on the sale of certain "qualified small business stock" as defined in Section 1202 of the Internal Revenue Code. Under prior law, stockholders were generally permitted to exclude from recognition only 50 percent of the capital gain on the sale of qualified small business stock, or 75 percent of the capital gain on such stock acquired after Feb. 17, 2009 and before Jan. 1, 2011. Under the Act, that exclusion is now increased to 100 percent, but only for qualified small business stock acquired between Sept. 28, 2010 and Dec. 31, 2010.

David O. Kahn is a tax partner at Latham & Watkins' San Diego and Los Angeles offices. He can be reached at david.kahn@lw.com.

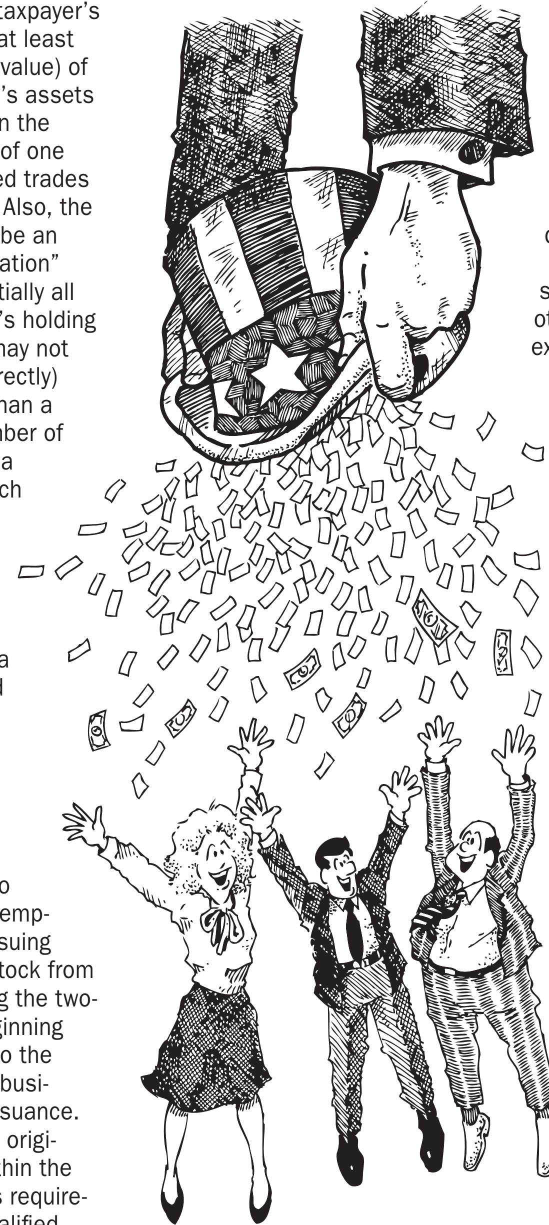
Mimi Z. Chao is an associate in the Los Angeles office of Latham & Watkins. She can be reached at mimi.chao@lw.com.

Qualified small business stock may generally only be issued by a "qualified small business," within the meaning of Code Section 1202, which usually requires that the issuer: be a domestic (U.S.) C corporation; have aggregate gross assets that do not exceed $50 million at all times on or after Aug. 10, 1993 through and immediately following the issuance of the qualified small business stock; and agree to submit such reports to the Internal Revenue Service and shareholders as the IRS may require to carry out the purposes of Section 1202.

In calculating whether a corporation meets the aggregate gross asset test, subject to certain exceptions, cash is included at face value and other assets are valued at their adjusted tax bases. To date, the IRS has yet to issue any reporting requirements applicable to qualified small businesses or qualified small business stock.

To be considered qualified small business stock, Section 1202 requires that securities meet several conditions. The stock must be "originally issued" to the taxpayer by a corporation that is a qualified small business on the date of issuance, and during substantially all of the taxpayer's holding period at least 80 percent (by value) of the corporation's assets must be used in the active conduct of one or more qualified trades or businesses. Also, the company must be an "eligible corporation" during substantially all of the taxpayer's holding period, and it may not (directly or indirectly) redeem more than a *de minimis* number of shares held by a taxpayer to which the qualified small business stock is issued, or certain related parties, within a four-year period beginning two years prior to the issuance of the qualified small business stock. Finally, there may be no "significant redemptions" of the issuing corporation's stock from any party during the two-year period beginning one year prior to the qualified small business stock's issuance.

Stock can be originally issued within the meaning of this requirement by the qualified small business directly or through an underwriter. It can be acquired in exchange for money or other property, but not other stock, or as compensation for services other than underwriting. Special rules apply to stock received by a partner from a partnership, as well as to stock received in a reorganization pursuant to Code Section 368(a)(1)(F) or solely through the conversion of other stock in the same corporation.



A qualified trade or business specifically includes start-up activities and certain research and experimentation activities. The term is otherwise defined as any trade or business other than certain specifically excluded activities (for example, professional activities such as law or medicine, banking and finance, farming, mining, and the operation of hotels and restaurants). For purposes of determining whether the 80 percent requirement is satisfied, a corporation is treated as owning its proportionate share of the assets of any subsidiary in which it holds more than 50 percent of the combined voting power or value. Cash or other assets held to meet the reasonable working capital needs of a qualified trade or business, or which are reasonably expected to be used within two years to finance research and experimentation in a qualified trade or business, count toward the 80 percent requirement, subject to certain limitations. Other than these cash assets, no more than 10 percent of the value of a corporation's assets less its liabilities may consist of securities of corporations other than controlled subsidiaries, and no more than 10 percent of the value of a corporation's total assets may consist of real estate not used in the active conduct of a qualified trade or business.

Certain entities that enjoy special tax privileges under other Code sections are excluded from the definition of an "eligible corporation." For example, domestic international sales corporations, regulated investment companies, real estate investment trusts and cooperatives may not issue qualified small business stock.

If the requirements associated with the issuance of qualified small business stock are satisfied, potentially significant tax benefits may apply. In addition to certain recognition deferral and rollover rights provided under Code Section 1045, prior to the enactment of the Act, Section 1202 allowed non-corporate taxpayers to exclude from gross income either 50 percent or 75 percent, depending on the date of issuance, of the gain arising upon the sale of qualified small business stock. In order to benefit from this exclusion, the qualified small business stock must have been held for more than five years. Gains realized on certain "offsetting short positions" are limited, and the amount of gain that can be excluded by any single taxpayer with respect to a particular issuer is generally limited to the greater of $10 million or 10 times the adjusted basis of the qualified small business stock. A portion of any excluded gain is treated as an item of tax preference for alternative minimum tax purposes.

The Act amends Section 1202 to provide for a temporary exclusion of 100 percent of gain realized on the disposition of qualified small business stock acquired on or after Sept. 28, 2010 and prior to Jan. 1, 2011. In addition, during this period, the excluded gain is not treated as a preference item for purposes of the alternative minimum tax, although the other limitations described previously continue to apply. This change results in a potentially significant federal income tax benefit to non-corporate investors, essentially reducing to zero the federal tax rate for capital gain on qualified small business stock to which the change applies.

In signing the legislation, President Obama predicted the measure would drive "capital to as many as one million small firms across America." Such an outcome will depend in part on how aware investors are of the tax break opportunity, and how quickly they act to take advantage of it.