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owning shares of small businesses that keep most of their workers and assets in the state.

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For almost two decades, California has provided a hefty tax break for residents owning shares of small businesses that keep most of their workers and assets in the state.

Not anymore. A court has thrown out the incentive, and now, to the frustration and anger of about 2,000 taxpayers, the state tax collector wants the money back, plus interest.

The Franchise Tax Board is going after four years' worth of these tax breaks. It recalculated the back taxes of people who benefited and mailed out a holiday surprise.

"It's a surreal situation," said Brian Overstreet of Healdsburg in the Sonoma County wine country. He said investors learned they owed taxes only in late December when the board sent out letters telling them the so-called qualified small-business capital gains tax incentive had been deemed unconstitutional.

"California is not a banana republic," said one critic, state Sen. Ted Lieu (D-Torrance). "California government should not punish innocent, law-abiding taxpayers retroactively just because it may have the power to do so."

Lieu says the state's move is questionable. In a strongly worded letter to the board, he called a staff decision to ask for the back taxes "an incredibly dangerous precedent" that could discourage businesses from locating in California.

Lieu is demanding that the board reverse its decision. He buttresses his argument by

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But to ensure the tax break would boost the California economy, lawmakers mandated that at least 80% of the companies' payroll costs and assets had to be located in the Golden State.

And that's how the statute fell afoul of the U.S. Constitution — 19 years after it became law. In August, a state appeals court, ruling on a lawsuit brought by an investor whose stock holdings didn't meet the 80%-in-California test, invalidated the law because it interfered with interstate commerce: granting a special benefit to stockholders in California small businesses that investors in similar out-of-state companies couldn't get.

Tax officials argue that the court's finding gave them no choice but to demand retroactive taxes.

"If the statute is invalid, it can't be enforced," said board spokeswoman Denise Azimi. "To cure discrimination we have to treat all taxpayers alike."

The only way to keep the tax break and still satisfy the court would be to drop the requirement that the small-business investment be primarily in California, making the incentive available to all investors, regardless of a company's location, she said.

Such a change can be done only by the state Legislature's passing a new version of the 1993 law, the board's attorneys insist.

That's the plan being put together by California Business Defense, a just-organized group, backed by the Bay Area Council, an alliance of large, high-tech companies from the San Francisco-Silicon Valley region.

"A lot of people are just waking up to the fact that this is happening," Overstreet said. "We want to recraft the issue and hand it back to the FTB to do what they do, which

is to enforce the law.”

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The FTB staff is wrong, wrong, wrong to say this issue requires action by the Legislature,” he said. “The FTB staff is misleading the public.”

The board, which comprises the state controller, the director of the Department of Finance and the chairman of the state Board of Equalization, has the authority to grant the tax break to all investors, Lieu asserted. It should reverse its demand for retroactive taxes, which Lieu says violates the due process requirement of the U.S. Constitution.

“It’s wrong to sock it to these taxpayers,” he said, “after they relied on the law the way it was written.”

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