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February 10, 2016

TO: Members
Joint Committee on Finance

FROM: Bob Lang, Director

SUBJECT: Senate Bill 404 and Assembly Bill 486: Eligibility for Early Stage Seed Tax Credits for Investments Made by the Fund of Funds Manager

Senate Bill 404 (SB 404) was introduced on December 3, 2015, and was referred to the Senate Committee on Revenue, Financial Institutions, and Rural Issues. On January 13, 2016, the bill was recommended for passage by that Committee on a vote of 5 to 0. The bill was referred to the Joint Committee on Finance (JFC) on February 2, 2016.

Assembly Bill 486 (AB 486) is an identical companion bill to SB 404 that was introduced on November 9, 2015, and was referred to the Assembly Committee on Ways and Means. On January 7, 2016, the bill was recommended for passage by that Committee on a vote of 11 to 2. The bill was referred to the JFC on February 1, 2016.

BACKGROUND

Fund of Funds Investment Program

The fund of funds investment program was established under 2013 Wisconsin Act 41, which created the program within the Department of Administration (DOA). Under Act 41, the state was required to commit $25 million GPR of capital to invest in venture capital funds, rather than making investments in businesses directly. The venture capital funds would then make direct investments in businesses. Funding for the program was provided to JFC's supplemental appropriation under the 2013-15 biennial budget act.

The bill contained provisions relating to the following: (a) investment manager compensation; (b) investments in businesses with headquarters in Wisconsin or which employ residents of Wisconsin; (c) investments in small businesses; (d) industries in which investments may be made; (e) diversity of geographic location of investments in businesses within Wisconsin; (f) private fund matching requirements; (g) limits, timing, and number of investments; (h) disclosure and reporting requirements; and (i) profit-sharing between the state and the investment manager.

The bill further specified that, in addition to the state's contribution of $25 million GPR, the investment manager must commit $300,000 of its own capital and raise at least $5 million from sources other than the state. In total, the bill provided that at least $30.3 million, including funds from private entities, would be available for the fund of funds investment program. In January, 2014, DOA selected an investment manager, Sun Mountain Kegonsa, LLC, through a request for proposal and evaluation process. In accordance with the process established under s. 16.295(3) of the statutes for approval of the investment management contract, a contract was approved and program funding provided through action of JFC in May, 2014.

State law requires that, of the statutorily required contributions to the state fund of funds investment program, the investment manager must commit at least half of those moneys to investments in venture capital funds within one year after the date the investment manager executes its contract with the state. The investment manager must commit all of those moneys to investments in venture capital funds within two years after the date of the contract. The contract was executed on June 3, 2015. Therefore, state law requires Sun Mountain Kegonsa, LLC to commit at least $15.15 million to venture capital funds by June 3, 2016, and to commit the remaining $15.15 million by June 3, 2017. Each venture capital fund receiving moneys from the state investment manager must commit at least half of the moneys it receives from the fund of funds manager in businesses within two years of the date it receives those moneys and must commit the remainder of those moneys in businesses within four years of the date it receives those monies.

Venture capital funds that receive moneys from the state must make new investments in one or more eligible businesses that are: (a) headquartered in this state; (b) employ at least 50% of their full-time employees, including any subsidiary or other affiliated entity, in this state; and (c) invest at least half of those moneys in one or more businesses that employ fewer than 150 full-time employees, including any subsidiary or other affiliated entity, when the venture capital fund first invests moneys in the business. Under the venture capital fund's contract with an eligible business receiving moneys through the state fund of funds investment program, the contract must include a provision that, if the business relocates its headquarters outside of Wisconsin, or fails to employ at least 50% of its full-time employees, including any subsidiary or other affiliate entity, in this state within three years after receiving the investment, the business must promptly pay to the venture capital fund the full amount of its investment in that business. The venture capital fund would then be required to reinvest those moneys in other eligible businesses. Eligible businesses under the state fund of funds program must be in the agriculture, information technology, engineered products, advanced manufacturing, medical devices, or medical imaging industries. The venture capital fund must attempt to ensure that moneys are invested in eligible businesses that are diverse with respect to geographic location in the state.

The investment manager indicated in its annual report for 2014-15, which was submitted by DOA to the Legislature in an attachment to a letter dated November 12, 2015, that the fund held its initial closing on June 3, 2015, had secured $5.7 million of private matching capital, including $500,000 of the manager's own moneys, from investors, and planned to continue raising funds from investors in the first quarter of calendar year 2016. This exceeds the statutory requirement by $400,000.

Early Stage Seed Investment Tax Credit Program

The early stage seed investment tax credit is a nonrefundable credit that can be claimed under the individual income tax, including the alternative minimum tax, the corporate income/franchise tax, and the insurance premiums tax. The credit is equal to 25% of the claimant's investment paid in the tax year to a certified fund manager that the fund manager invests in a qualified new business venture (QNBV) certified by the Wisconsin Economic Development Corporation (WEDC).

The aggregate amount of early stage seed investment tax credits and angel investment tax credits (which are also administered by WEDC) that can be claimed per calendar year is $30.0 million. Credits not allocated by WEDC cannot be carried forward to future years. The aggregate amount of investment in any one QNBV that may qualify for angel investment or early stage seed investment credits is $8.0 million. Investments in a QNBV must be maintained in the business by the certified fund manager for at least three years.

WEDC is required to certify QNBVs and fund managers and to perform other administrative functions related to the allocation and transfer of credits, revocation of certifications, verification of investments and credits, and processing and compiling reports. Businesses and fund managers must apply to WEDC to be certified.

Qualified New Business Venture. A business may be certified as a QNBV by WEDC only if it meets certain conditions. For example, the business must have its headquarters in Wisconsin, have at least 51% of its employees employed in the state, have fewer than 100 employees at the time of initial certification, and have been operating in Wisconsin for no more than 10 years and received no more than $10 million in private equity investment at the time of initial certification. In addition to statutory requirements, WEDC's policies and procedures require that it consider additional factors in certifying a QNBV, such as whether the business is in a targeted industry or what the percentage of funds that the business will spend in Wisconsin. According to WEDC, there were approximately 200 active QNBVs as of February 2, 2016

Certified Fund Manager. In order to be eligible for investments that qualify for early stage seed investment tax credits, the fund manager must be certified by WEDC. WEDC is required to consider certain past experience and performance measures when determining whether to certify an investment fund manager. Under WEDC's policies and procedures, it also evaluates a number of factors when determining whether to certify a fund manager, such as the portion of the investment fund's capital the fund manager expects to invest in QNBVs, the geographic distribution of funds, and whether the funds focus on targeted industries or targeted group members, as determined by WEDC.

Venture capital funds must follow a verification process in order to receive early stage seed tax credits based on eligible investments. For each investment in the QNBV, the certified fund manager must provide WEDC with a copy of its investor agreement and proof of investment. Certain criteria apply for an investment to be deemed eligible to receive a credit. Based on a review of submitted materials, WEDC issues a verification form to the certified fund manager stating the amount of credits that may be claimed. Investors must submit a copy of the certification for tax benefits and the verification form, including the amount of tax benefits that may be claimed and the date and amount of the investment, with the investor's tax return. WEDC can revoke the verification of tax credits if the investment in the QNBV is not maintained for a minimum of three years, with certain exceptions.

Carry Forward/Transferability of Credits. If an early stage seed tax credit is not entirely used to offset state income, franchise, or premiums taxes, the credit may be carried forward and used to offset future tax liability for up to 15 years. Alternatively, a person who makes an investment in a certified fund and who is eligible to claim the credit may sell or otherwise transfer the credit to another person to offset that person's income, franchise, or insurance premiums tax liability. A certified fund manager is required to notify both WEDC and the Department of Revenue (DOR) of the transfer and submit a copy of the transfer documents with the notification. Any person selling or otherwise transferring the credit must pay WEDC a fee of up to 5% of the amount of the credit sold or transferred. A person may sell or otherwise transfer a credit no more than once in a 12-month period.

Administration. Partnerships, limited liability companies (LLCs), and tax-option corporations (S corporations) cannot claim the credit, but the eligibility for, and the amount of, the credit is based on their payment of amounts eligible for the credit. A partnership, LLC, or S corporation must compute the amount of credit that each of its partners, members, or shareholders can claim and provide that information to each of them. Partners, members, and shareholders can claim the credit in proportion to their ownership interests or as specially allocated in their organizational documents. The claimant would have to include a copy of the claimant's certification for tax benefits with the claimant's return in order to claim the credit.

Special Allocation of Credits. For most state business tax credits, a partnership, LLC, or S corporation that computes the amount of credit available to each partner, member, and shareholder must allocate the credit in proportion to their ownership interests. Under the early stage seed credit, a partnership, LLC, or S corporation must determine the computation of the 25% credit limitation at the entity level, rather than the claimant level, and may allocate the credit among claimants who make investments in the manner set forth in the entity's organizational documents. Therefore, it is possible that a claimant could receive a portion of the credit that differs from its proportional ownership stake in the partnership, LLC, or S corporation, pursuant to the entity's organizational documents.

Credit Allocations Under the State Fund of Funds Investment Program

Under the Badger Fund of Funds I, L.P. Limited Partnership Agreement, as amended through June 3, 2015, the state, Sun Mountain Kegonsa, LLC (the fund of funds manager), and other investors in the fund of funds program are partners in a limited liability partnership (LLP). Under the LLP, the fund of funds manager is considered the general partner and the state and other persons investing in the program are limited partners. The LLP agreement contains specific provisions governing tax allocations. Specifically:

> "…if tax credits, deductions, or the like are available to the Partnership or to the Limited Partners as a result of their interests in the Partnership, and if one or more Partners is unable to benefit from such credits, deductions, or the like, the General Partner may, to the extent permitted by applicable law, allocate such tax credits, deductions, or the like to the other Partners in such manner as the General Partner deems equitable. To the extent that applicable law does not allow the General Partner to make such allocations, but applicable law allows the transfer of such credits, deductions, and the like, each Limited Partner that is unable to benefit from such credits, deductions, and the like will transfer such credits, deductions, and the like to other Partners in such proportions as the General Partner may deem equitable, without further consideration."

After consulting with DOR, it appears that the LLP agreement would allow the total amount of investments made by the fund of funds manager to an investment manager certified by WEDC that were invested in QNBVs to be eligible for early stage seed credits. State law would permit the credit to be computed on any eligible investment made by the fund of funds manager, and the LLP agreement would allow the fund of funds manager to allocate the credits among partners that are able to use the credit without further consideration of the limited partners. Under the agreement, it is reasonable to assume that any early stage seed investment credits generated from investments made with moneys contributed by the state would be allocated among the general partner and the other limited partners that are able to claim the credit.

As previously noted, state law requires that the investment manager must invest: (a) the $25 million GPR contributed by DOA; (b) at least $300,000 of the investment manager's own moneys; and (c) at least $5 million that the investment manager raises from sources other than DOA. If the fund of funds manager were to raise the minimum amounts required under state law ($30.3 million) and invest all of those moneys into investment fund managers certified by WEDC that invest those moneys in eligible QNBVs, the Badger Fund of Funds I, L.P. could be eligible for up to $7,575,000 of early stage seed credits. [For purposes of this example, management fees that would be charged by the fund of funds manager are not considered.] If the fund of funds manager were to distribute those credits among non-state partners in proportion to their investment, it is possible that the fund manager and other limited partners could be eligible to receive more than $1.40 in credits for each $1 invested in the Badger Fund of Funds I, L.P. To the extent that the fund of funds manager were to raise monies in excess of the statutory minimums, the amount of early stage seed credits available per dollar invested by the fund manager and other limited partners would diminish, compared to this example. As previously noted, the fund of funds manager has already raised $400,000 of investments above the minimum statutory requirement.

At the time Act 41 was enacted, there had been no consideration by the Legislature or the executive agencies that submitted fiscal notes that early stage seed credits could be claimed for DOA moneys contributed to the state fund of funds program. At that time, an investment manager had not been selected and the future structure of the program was unknown. However, current law appears to permit early stage seed credits to be earned on all investments made by the fund of funds manager, including the $25 million GPR contributed by DOA, under the partnership agreement entered into by the DOA Secretary.

According to DOA, when the partnership agreement was negotiated with the investment manager, the provision governing tax allocations that allows for tax credits to be allocated among the partners was not intended to include the state's capital contribution, such that the $25 million GPR contributed by the state could be allocated to other partners. However, DOA has been informed that this appears to be allowable and, at this time, has not indicated that it would seek to amend the contract to specify that the state's contribution could not be allocated to other partners for tax purposes. Therefore, it is assumed that other partners will claim the tax credit based on eligible investments made with the state's contribution to the fund of funds.

SUMMARY OF BILLS

SB 404/AB 486 would specify that investments made by the fund of funds investment manager in venture capital funds managed by WEDC certified fund managers could be used as the basis for claiming the early stage seed investment credit. State law would specify that investments eligible for the credit would include: (a) the $25 million GPR paid by DOA to the fund manager; (b) at least $300,000 of the investment manager's own moneys; and (c) at least $5.0 million that the investment manager raises from sources other than DOA. The bill would explicitly codify the interpretation of current law, as was previously described. Additionally, it appears that the bill would allow such moneys contributed to the fund of funds to be used as the basis for calculating the credit regardless of how the entity investing those moneys was organized.

This provision would take effect on the day following publication of the bill.

FISCAL EFFECT

As noted previously, at the time Act 41 was enacted, there had been no consideration that the $25 million GPR contributed by DOA to the state fund of funds manager could be used by other entities to claim early stage seed credits on those investments. This situation was unknown to this office when we prepared tax revenue estimates in late January. Those estimates assumed that the $5.3 million contributed by private investors could potentially be used to claim the credit, but not the $25 million GPR invested by the state. In addition, DOR was not aware of this situation when it issued its fiscal note for SB 404/AB 486.

There are a number of uncertainties in estimating the fiscal effect of this provision. It is reasonable to assume that some amount of investments made by the fund of funds manager will not be made in QNBVs eligible for the early stage seed credit, since the qualifications for what types of businesses can receive investments through the fund of funds program include different, but overlapping criteria compared to the qualifications for which businesses are determined to be eligible QNBVs. Conversely, it is plausible that investors that would otherwise not invest in this state would choose to invest in the state fund of funds program because of the generous amount of early stage seed credits available for each dollar invested in the program, resulting in an increase in investments eligible for the credit. It is estimated that, in total, the $25 million GPR invested by the state will result in an additional $6.3 million (25% of $25 million) of early stage seed credits. Some uncertainty exists with regards to the timing for when investments might be made by venture capital companies in businesses eligible to receive investments through the fund of funds program within the aforementioned statutory requirements of the program and when tax credit claims would be filed with DOR. Based on the statutory limits, we believe that a reasonable estimate for when eligible credit claims will be used would be to reduce tax revenues from current estimates by $2.1 million in 2016-17 and 2017-18, $1.1 million in 2018-19, $700,000 in 2019-20, and $300,000 in 2020-21 under both current law and under SB 404/AB 486.

As noted, until recently, it was unknown that the state's investment in the fund of funds investment program would be eligible to receive state early stage seed investment tax credits. If the Legislature's intent was to exclude funding provided by the state from the amounts eligible for the credit and, instead, clarify that investments made with moneys invested by the fund of funds manager and from other non-state sources are the only investments eligible for the credit, the bills could be amended, or a separate bill could be introduced, to clarify the Legislature's intent. If such a clarification to current law were enacted, no adjustments would need to be made to our agency's revenue estimates and an estimated $6.3 million would be available for other legislative priorities between 2016-17 and 2020-21. No investments have been made to date by the investment fund manager.

Prepared by: Sean Moran and Rachel Janke