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Angel Investment and Early Stage Seed Investment Tax Credits -- Expansion and Technical Modifications (General Fund Taxes -- Individual and Corporate Income and Franchise Taxes)

Bill Agency

[LFB 2007-09 Budget Summary: Page 162, #14]

CURRENT LAW

The angel investment tax credit provides a tax credit for an angel investment in a qualified new business venture, while the early stage seed tax credit provides a tax credit for an investment by a fund manager in a qualified new business investment venture (certified business). The angel investment tax credit can be claimed under the individual income tax and is equal to 12.5% of the claimant's bonafide angel investment made directly in a qualified new business venture in a tax year. The 12.5% tax credit can be claimed for two years, beginning with the tax year as certified by the Department of Commerce. The maximum amount of a claimant's total investment that may be used as a basis for an angel investment tax credit is $500,000 for each investment made directly into a certified business. The maximum aggregate amount of angel investment tax credits that may be claimed for a tax year is $3 million. The maximum total amount of tax credits that can be claimed for all tax years is $30 million. Also, the maximum total amount of investment in a qualified new business venture that qualifies for tax credits is $4 million, of which no more than $1 million can come from angel investors.

The early stage seed investment credit can be claimed under the individual income and corporate income and franchise taxes and is equal to 25% of the claimant's investment paid in the tax year to a fund manager that the fund manager invests in a business certified by the Commerce (qualified new business venture). The maximum aggregate amount of early stage seed investment tax credits that can be claimed for a tax year is $3.5 million. The maximum total amount of tax credits that can be claimed for all tax years is $35 million. The maximum total amount of investment in a certified business that qualifies for tax credits is $4 million, of which no more than $1 million can come from angel investors. Up to $2 million in aggregate investment by a certified fund manager in a certified business qualifies for tax credits.

GOVERNOR

Make the following modifications to the angel investment tax credit under the individual income tax and the early stage seed investment tax credit under the individual income and corporate income and franchise taxes:

a. Increase the total amount of angel investment tax credits that can be claimed for all tax years by $17.5 million, from $30 million to $47.5 million. For tax years beginning after December 31, 2007, the aggregate amount of tax credits that could be claimed each year would be increased by $2.5 million, from $3 million to $5.5 million. The maximum amount of investment that could be used as the basis for a tax credit would be increased from $500,000 to $2 million.

b. Increase the total amount of early stage seed investment tax credits that could be claimed for all tax years by $17.5 million, from $35 million to $52.5 million. For tax years beginning after December 31 2007, the aggregate amount of tax credits that could be claimed each year would be increased by $2.5 million, from $3.5 million to $6 million

c. Authorize the Department of Revenue (DOR), in consultation with Commerce, to carry forward unclaimed tax credit amounts for a given year to subsequent years for allocation.

d. Require that, in order to claim a tax credit, an investment must be kept in a certified business, or with a certified fund manager, for at least three years.

e. Eliminate statutory provisions that require the angel investment and early stage seed investment tax credits to be added to income. Instead, the Wisconsin adjusted basis of any investment for which a tax credit is claimed would have to be reduced by the amount of the credit that is offset against Wisconsin income taxes. The Wisconsin basis of a partner's interest in a partnership, a member's interest in a limited liability company (LLC), or stock in a tax-option corporation, would be adjusted to reflect the basis adjustment. This provision would first apply to tax years beginning on January 1, 2007.

It is estimated that these provisions would reduce individual income tax revenues and corporate income and franchise tax revenues each by $1.4 million in 2007-08 and by $2.5 million in 2008-09. Consequently, the total estimated reduction in state income and franchise tax revenues would be $2.8 million in 2007-08 and $5 million in 2008-09.

DISCUSSION POINTS

1. Recent economic studies have identified certain linkages between entrepreneurship and economic growth. Entrepreneurial enterprises are viewed as significant factors for increasing employment and productivity. Entrepreneurs can be distinguished from small business owners as persons who organize, operate, and assume risk for a business venture. Growth rates and desired outcomes most often distinguish entrepreneurial ventures from other small businesses. Typically, entrepreneurial companies target annual growth rates of 15% to 20% in either revenues, employment, or both. Entrepreneurs also usually intend to build businesses that provide an innovative product or service.

One econometric study using a Census Bureau database (Acs, Armington, 2004) found that higher rates of entrepreneurial activity were strongly associated with faster growth of local economies. New organizations were able to take advantage of information useful to business produced through economic activity in the area (knowledge externalities). Higher levels of employment growth rates were also strongly positively associated with such entrepreneurial activities. The authors found that, for 1995-96, establishments that were less than two years old accounted for all net national job growth. However, establishments that were at least 10 years old accounted for 60% of total employment and offered jobs with good prospects for continued employment.

Another area of research views entrepreneurship as a critical spur for commercial introduction of new goods and services, and the opening of new markets to innovations. Researchers focus on the role of economic experiments in economic growth (Rosenberg, 1994). Entrepreneurs engage in activities referred to as "extreme experiments," since start-up companies are not constrained by the limits of old technologies, traditional methods of organizing production, or the need to serve established markets. Entrepreneurs can be more aggressive in pursuing radical approaches to the creation of economic value. In addition, unlike purely scientific experiments, economic experiments compete with other economic experiments. As a result, the value of start-up activity is not limited to the value created by new businesses, but also includes benefits from increased competitive pressure on established firms. Entrepreneurship also contributes to the range and diversity of economically useful knowledge. Collectively, entrepreneurs are often able to pursue a more diverse and idiosyncratic range of technical experimentation approaches to a potential technology, which increases the possibility of achieving a technological breakthrough (Fleming 2001, Fleming and Sorenson 2003). The value from new technologies relies on the ability to apply that new technology to new markets in new ways, and market experimentation can significantly enhance the range of potential market applications (Shane, 2000). Entrepreneurs undertake organizational experiments to develop an organization to best take advantage of specific technical and market opportunities.

2. As a new business venture progresses from the initial idea and business plan until it reaches maturity through an initial public offering (IPO), acquisition, or buyout, it also moves through funding stages. Each of these stages involves certain potential sources of capital for the business that can differ from stage to stage. The exact number of financing stages can vary from

venture to venture. Some firms will have no more than two stages of financing after the seed stage, while others might require a series of financing stages during expansion. Also, the specific number of stages described varies among financial practitioners. The typical financing stages for new business venture financing and the sources of funds at each stage include the following:

Seed/Concept. The venture is in the process of examining idea feasibility and its product or service is not fully developed. Funds are used for product and/or service development (including prototype development), patent filings, market surveys and research, incorporation, management recruitment, legal structuring for investment, and development of a business plan if product or service development is successful. Sources of capital for the venture include the entrepreneur's personal savings and earnings, credit cards, and monies from friends and relatives. New ventures might qualify for U.S. Small Business Innovation Research (SBIR) program funding. Phase I awards provide funding to support exploration of the technical merit or feasibility of an idea or technology. Phase II provides funds for research and development (R&D) and evaluation of commercialization potential. In some cases, angel investors provide seed financing.

Start-Up. Product or service development could be complete, in testing, or a pilot project. At least one principal is working full-time, market studies are complete, and a business plan is also complete. The venture may be in business and generating some revenues. Key management is being assembled or is in place. Generally, this is the stage at which outside funding sources are sought. A primary source of capital at this stage would be angel investors or angel networks that provide financing from their own funds. Banks might provide financing if the entrepreneur has a solid credit history, venture-related experience, and can offer collateral, such as a house. Early stage venture capitalists may provide funding in some cases.

First-Stage. The firm has begun production or is providing a service. Management and employees are on the job, and the company is making some sales. Further funding is needed to increase production or services, increase productivity, and build the sales organization and distribution system. Angel investors and networks continue to be a source of capital. This is also the stage where venture capital investors like to begin financing.

Second Stage. The company is producing and shipping products, or providing services to customers. A significant amount of revenues are developing, and accounts receivable and inventory are accumulating. However, the company may not yet be profitable. Second level management is being identified and hired. Financing at this stage is working capital for further expansion, and for increasing marketing, accounts receivable, and inventory. Angel investors may still provide some funding. If monthly cash flow is at a break-even point, banks may provide a line of credit. Venture capital firms specializing in later stage funding provide financing.

Third Stage. At this stage the company is typically looking for a major expansion of operations. Sales are increasing and second level managers are in place. Internal funds, including profits and lines of credit, are insufficient to support plant expansion, product improvement, marketing, and other assets and the internal capabilities necessary for stronger sales. Because of the ability to raise substantial amounts of capital, venture capital funds are a primary source of capital at this level of development. Corporate venture investments can also be a source financing at this stage.

Bridge/Mezzanine. Mezzanine financing is typically a hybrid of debt and equity financing that is used to provide funds for expansion of an existing company. Bridge financing is interim financing used to meet short-term cash flow needs until more permanent financing (usually larger amounts) is secured. Mezzanine or bridge financing is a short-term form of providing funds used to prepare a company for going public through an IPO, or for a leveraged buyout or acquisition. The funds are used to remove accumulated debt from the firm's balance sheet, buy out early investors and founders if necessary, and to pay other costs related to the public offering of stock, buyout, or acquisition of the company. This funding may come from a venture capital firm or bridge financing specialist, who are usually paid from the proceeds of the IPO, acquisition, or buyout.

IPO/Acquisition/Buyout. Traditionally, entrepreneurs and investors cashed out their interests in the firm through an initial public offering of stock in the company. However, acquisitions by other firms and management buyouts of the firm are becoming more common ways of realizing the returns from investing in the company.

3. For the purpose of claiming the angel investment tax credit, an "angel investor" is defined as an accredited investor that makes a bonafide angel investment. A "bonafide angel investment" means an investment made by an "accredited investor" or angel investment network in a qualified new business venture. An "accredited investor" is a high net worth individual who: (a) invests his or her own monies in a qualified new business venture; (b) does not own, control, or hold power to vote 20% or more of the outstanding securities of the qualified new business venture in which the eligible investment is proposed; and (c) is not a spouse, parent, grandparent, sibling, child, stepchild, or grandchild of an individual who owns, controls, or holds power to vote 20% or more of the outstanding securities of the qualified new business venture in which the eligible investment is proposed. In addition, at the time the original investment is made, "accredited investor" includes an individual who meets any of the following requirements:

a. The investor is an individual with a net worth, or joint net worth, together with his or her spouse, in excess of $1,000,000;

b. The investor is an individual who had income in excess of $200,000 in each of the prior two years, or a joint income with his or her spouse in excess of $300,000 in each of those years, and reasonably expects to reach the same income level in the current year;

c. The investor is an individual who is a director, executive officer, or general partner of the issuer of securities being offered or sold;

d. The investor is an individual who has knowledge and experience in financial and business matters, and he or she is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that the purchaser comes within this description.

An "angel investment network" is defined as an entity comprised of accredited investors organized for the sole purpose of making a bonafide angel investment in a single qualified new business venture. A "bona fide angel investment" means an investment made by an accredited investor or an angel investment network in a qualified new business venture.

4. Certified fund managers that make investments in certified businesses may claim the early stage seed investment tax credit. Fund managers seeking certification are required to submit an application to Commerce. In determining whether to certify an applicant as a certified fund manager, Commerce is required to consider all of the following factors: (a) the applicant's experience in managing venture capital funds and investing in high growth, early stage businesses; (b) the past performance of investment funds managed by the applicant and businesses assisted by the applicant; (c) the level of investment in the fund to be managed by the applicant that it expects to invest in qualified new business ventures; (d) geographic distribution; (e) focus on targeted industries or target group members; (f) ability to access follow-on funding; (g) services provided; (h) commitment to Wisconsin; and (i) administrative and management fees.

The attachment lists nine venture capital funds that have been certified by Commerce.

5. In order to qualify for tax credits, an investment must be made in a "qualified new business venture" (certified business). A "qualified new business venture" is an early stage business conducting precommercialization activity related to proprietary technology that is certified by Commerce. To be certified, a businesses must submit an application to Commerce in each tax year for which the business wants to be certified. A business may be certified and maintain its certification as a qualified new business venture only if it satisfies all of the following:

a. It has its headquarters in this state;

b. At least 51% of the employees employed by the business are employed in the state;

c. It is engaged in, or has committed to engage in, one of the following: (1) developing a new product or business process; or (2) manufacturing, agriculture, or processing or assembling products, and conducting research and development;

d. It is not engaged in real estate development, insurance, banking, lending, lobbying, political consulting, professional services provided by attorneys, accountants, business consultants, physicians, or health care consultants, wholesale or retail trade, leisure, hospitality, transportation, or construction;

e. It has not received more than $1 million in aggregate investments that have qualified for angel investment tax credits;

f. It has not received aggregate private equity investment of more than $10 million, and;

g. At the time it is certified, it meets both of the following: (1) it has less than 100 full-time equivalent employees; and (2) has been in operation for not more than seven consecutive years.

Commerce has certified 67 firms as qualified new business ventures.

6. Under SB 40, the limit on the annual amount of angel investment and early stage seed investment tax credits that could be claimed would each be increased by $2.5 million, to $5.5 million, and $6.0 million, respectively. The total amount of angel investment tax credits that could be claimed would be increased to $47.5 million, while the total amount of early stage seed investment tax credits that could be claimed would increase to $52.5 million. In addition, unused tax credit amounts in any year could be carried forward to future years for allocation.

Conventional financial theory asserts that, in perfect financial markets, the return required for investment in a project by a rational investor is influenced by the return on investment and the risk of the project. Typically, the investor will allocate funds to the projects with the highest relative present value or internal rate of return based on an evaluation of each project. By increasing the rate of return or present value of the investment, the tax credits reduce some of the risk of the investment. The credits provide an incentive for angel investors and venture capital funds to invest in Wisconsin entrepreneurial ventures. To the extent the incentive is effective, the proposed tax credit expansion would increase the amount of potential funding available for Wisconsin entrepreneurs. In turn, this would increase the number of ventures that were undertaken and that successfully grow into mature businesses.

7. The angel investment and early stage seed investment tax credits are supported because, given the risk associated with angel and venture capital investments, individual angel and venture capitalists will invest less capital and in fewer projects than would be optimal for the state. However, there is often disagreement among policymakers as to the effectiveness of such incentives. A Northstar Economics report about risk capital in Wisconsin (Risk Capital in Wisconsin: A Progress Report, Ward, 2006) estimated that angel investment activity in the state exceeded $50 million in 2005, of which $15.5 was associated with the angel investment tax credit. A study of a Quebec incentive program found that tax incentives for venture capital were not effective in Quebec (Carpentier and Suret, 2005). The Angel Capital Association in Vienna, Virginia, has officially taken a neutral position on pending federal legislation that would create a 25% federal angel investment tax credit. The Association indicates that it is unclear that the credit would lead to investments, and the credit could lead an investor to make bad deals or cause unqualified individuals to invest in projects.

8. According to the Department of Commerce, in 2005, a total of 368 angel investors invested $15.4 million in 23 qualified business ventures, and claimed $3.0 million in angel investment tax credits. In 2006, 316 angel investors, invested $10.5 million in 30 qualified business ventures and claimed $2.4 million in tax credits. As a result, about $600,000 in potential angel investment tax credits were not claimed in 2006.

In 2005, three different investments totaling $500,000 were made by certified venture funds in two qualified businesses, and $125,000 in early stage seed investment tax credits were claimed. In 2006, 12 different investments totaling $5.7 million were made in eight certified business ventures, and $1.4 million in tax credits were claimed. Consequently, over $4.3 million in early stage seed investment tax credits were not claimed in 2005; while about $3.1 million in tax credits were not claimed in 2006.

9. The estimated fiscal effect of expanding the tax credits in the bill is a reduction in individual income and corporate income and franchise tax revenues of $2.8 million in 2007-08 and $5.0 million in 2008-09, and assumes that the entire amount of authorized tax credits would be claimed for each year of the biennium. The amount of angel investment tax credits claimed has essentially been the same as the maximum amounts authorized. Commerce and DOR staff indicate that, even though the full amount of early stage seed investment tax credits were not claimed in 2005 and 2006, the amount of credits claimed has increased and they expect the trend to continue. In addition, it typically takes time to establish a venture capital fund and to raise funds for investment. Thus, in future years more venture fund investments are expected. However, the Committee could choose to adopt the expansion of angel investment tax credits and eliminate the expansion of the early stage seed investment tax credit. If utilization of the early stage seed investment credit reaches the maximum credit limit, Commerce could include a proposed expansion in its 2009-11 biennial budget request.

10. The maximum amount of investment that could be used as the basis for the angel investment tax credit would be increased from $500,000 to $2 million. This addresses cases where angel networks have been limited in receiving tax credits for follow-on (later stage) investments in qualified businesses. In order to prevent early cash-outs, the bill would require investments to be kept in a certified business, or with a certified fund manager, for at least three years.

11. Current law requires that angel investment and early stage seed investment tax credits be added to the taxable income of the claimant in the year the credits are claimed. Typically this prevents a taxpayer (business) from claiming a deduction and a tax credit for the same expense. However, these credits are usually claimed by outside investors in the business. The taxpayers are not typically deducting the investment on which the tax credit is based. The bill would eliminate the requirement that the tax credits be added to income, and instead require that the Wisconsin basis of any investment for which a tax credit is claimed be reduced by the amount of the credit that is offset against Wisconsin income or franchise taxes. This is similar to the treatment provided for the federal investment tax credit. The Wisconsin basis of a partner's interest in a partnership, a member's interest in an LLC, or stock in a tax-option corporation, would be adjusted to reflect the basis adjustment. Generally, the provisions in the bill would first apply to tax years beginning on January

1, 2007. However, effective date provisions do not apply to elimination of the credit add-back. A technical clarification is necessary to specify that the effective date applies to elimination of add-back provisions as well. Eliminating the add-back of tax credits and, instead, reducing the basis of the investment would have a minimal fiscal effect.

ALTERNATIVES TO BILL

1. Adopt the Governor's recommendation to: (a) increase the total amount of angel investment tax credits that can be claimed for all tax years by $17.5 million, from $30 million to $47.5 million and, for tax years beginning after December 31, 2007, increase the aggregate amount of tax credits that could be claimed each year by $2.5 million, from $3 million to $5.5 million; (b) increase the total amount of early stage seed investment tax credits that could be claimed for all tax years by $17.5 million, from $35 million to $52.5 million, and for tax years beginning after December 31 2007, increase the aggregate amount of tax credits that could be claimed each year by $2.5 million, from $3.5 million to $6 million; (c) authorize the Department of Revenue, in consultation with the Department of Commerce, to carry forward unclaimed tax credit amounts for a given year to subsequent years for allocation. (d) increase the maximum amount of investment that could be used as the basis for a tax credit from $500,000 to $2 million; (e) require that, in order to claim a tax credit, an investment must be kept in a certified business, or with a certified fund manager, for at least three years; and (f) for tax years beginning on January 1, 2007, eliminate statutory provisions that require the angel investment and early stage seed investment tax credits to be added to income and, instead, require the Wisconsin adjusted basis of any investment for which a tax credit is claimed to be reduced by the amount of the credit that is offset against Wisconsin income taxes.

ALT 1	**Change to Bill**		**Change to Base**	
	Revenue	Funding	Revenue	Funding
GPR	$0	$0	- $7,800,000	$0

2. Modify the bill to delete one or more of the following components of the Governor's proposal:

a. The increase in the total amount of angel investment tax credits that can be claimed for all tax years by $17.5 million, from $30 million to $47.5 million and, for tax years beginning after December 31, 2007, the increase in the aggregate amount of tax credits that could be claimed each year by $2.5 million, from $3 million to $5.5 million.

ALT 2a	**Change to Bill**		**Change to Base**	
	Revenue	Funding	Revenue	Funding
GPR	- $3,900,000	$0	$3,900,000	$0

b. The increase in the total amount of early stage seed investment tax credits that could be claimed for all tax years by $17.5 million, from $35 million to $52.5 million, and for tax years beginning after December 31, 2007, the increase in the aggregate amount of tax credits that could be claimed each year by $2.5 million, from $3.5 million to $6 million;

ALT 2b	**Change to Bill**		**Change to Base**	
	Revenue	Funding	Revenue	Funding
GPR	- $3,900,000	$0	$3,900,000	$0

c. Authorization for DOR, in consultation with Commerce, to carry forward unclaimed tax credit amounts for a given year to subsequent years for allocation.

d. The increase in the maximum amount of investment that could be used as the basis for a tax credit from $500,000 to $2 million.

e. For tax years beginning on January 1, 2007, the provision that would repeal statutory provisions that require the angel investment and early stage seed investment tax credits to be added to income and, instead, require the Wisconsin adjusted basis of any investment for which a tax credit is claimed to be reduced by the amount of the credit that is offset against Wisconsin income taxes.

3. Modify bill provisions that eliminate the add-back of angel investment and early stage seed investments to clarify that the effective date of January 1, 2007, applies to these provisions.

4. Delete provisions.

ALT 4	**Change to Bill**		**Change to Base**	
	Revenue	Funding	Revenue	Funding
GPR	$7,800,000	$0	$0	$0

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Attachment

ATTACHMENT

Certified Venture Capital Funds

Avolte Venture Partners LP	Madison
Baird Venture Partners I Limited Partnership	Milwaukee
Baird Venture Partners I(B) Limited Partnership	Milwaukee
BLP Affiliates Fund Limited Partnerships	Milwaukee
Kegonsa Co-Invest Fund I, LLC	Madison
Kegonsa Seed Fund I	Madison
New Capital Fund LP	Appleton
Phenonenelle Angels Fund I, LP	Madison
Venture Investors Early Stage Fund IV Limited Partnerships	Madison