

A TENNESSEE SEED CAPITAL QUALIFIED INVESTMENT TAX CREDIT: A SURVEY AND CONCRETE PROPOSAL FOR LEGISLATIVE ACTION¹

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EXECUTIVE SUMMARY

New and seed-stage technology-oriented companies play a vital role in a state's economy. Because of their high-risk nature, however, these companies have limited access to venture capital. "Angel investors" often are the only source of capital for companies operating in the "equity gap" that exists between the founder's funds and subsequent financing rounds from traditional banks and venture capital funds. Several states have enacted qualified investment tax credit programs, also known as "angel investor programs," to encourage individuals to invest in these seed-stage companies. Angel investor programs are economic development tools designed to provide an angel investor a state income tax credit in the amount of a defined percentage, generally 20% to 40%, of an investment in a seed-stage company.

This Article proposes a qualified investment tax credit program for Tennessee that would provide individuals a state income tax credit in the amount of 25% of a qualifying investment into a seed-stage technology-oriented company or any other company that has the potential to bring significant capital into the state. A taxpayer may claim the proposed credit as an offset of up to 50% of the taxpayer's Tennessee income tax liability. The General Assembly may limit the annual amount of credits available to taxpayers to minimize the impact on the state's revenue collections. This qualified investment tax credit program is an essential component in Tennessee's strategy to successfully compete in the emerging technology-based economy. In addition, the General Assembly's enactment of this program will demonstrate Tennessee's dedication to addressing the equity financing needs of a crucial segment of the state's economy. The following summarizes the key

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components of the proposed Tennessee Seed Capital Qualified Investment Tax Credit program.

What is the Tennessee Seed Capital Qualified Investment Tax Credit program?

The program provides a tax credit that a taxpayer may claim against the taxpayer's state income tax, also known as the Hall income tax, in the amount of up to 25% of a taxpayer's qualified investment.

What is a qualified investment?

A qualified investment is a cash purchase of a qualified business's equity securities in an amount of up to \$200,000. The qualified business must expend the investment proceeds towards plant and equipment, research and development, or working capital.

What is a qualified business?

A qualified business is a Tennessee corporation, partnership, or limited liability company that (i) operates in a technology-oriented trade or business or brings significant capital into Tennessee, (ii) is fewer than three years old, (iii) has annual gross sales of \$3 million or less, (iv) has not received qualified investments in excess of \$600,000, and (v) does not participate in certain service-oriented or real estate-related businesses.

Are there any restrictions on claiming the credit?

Only natural persons who are independent of the qualified business may claim the credit. The program limits the amount of credit that a taxpayer may claim to the lesser of (i) 50% of the taxpayer's state income tax liability or (ii) \$50,000. The taxpayer may carry forward any excess credit amount to subsequent years.

What is the amount of available credits under the program?

The General Assembly will determine the annual amount of credits available. However, this Article assumes that the program will provide \$3,000,000 in available credits for the program's initial year and \$4,000,000 for each subsequent year.

What happens when taxpayers do not request all of the available credits?

The program administrator will add any remaining available tax credits at year-end to the subsequent year's amount of newly available tax credits.

What happens when taxpayers request credits in excess of the available credits?

The program administrator will grant each taxpayer a prorated share of the available tax credits. Taxpayers may claim their remaining prorated credit in subsequent years.

Who administers the program?

The General Assembly will appoint the program administrator. The administrator will likely be a state agency that has adequate human and financial resources to effectively administer the program.

What is the cost to the state?

The program's maximum cost to the State is the amount of available tax credits in a given year plus any additional administrative costs in excess of the program administrator's annual budget.

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I. INTRODUCTION

The components of today's "vibrant and prosperous" economy are "fundamentally different from those of the past."³ Specifically, a "New Economy"⁴ has developed and is generally characterized as a "movement from a tangible-asset to an intangible[-]asset-based economy."⁵ Today, "knowledge-driven innovation, science, and technology are critical to job and wealth creation,"⁶ and "[c]apital, particularly seed and venture capital, is critical to fuel the new businesses that will drive" state economies.⁷

Tennessee is a fertile environment for new high technology companies. For example, Tennessee is home to some of the nation's finest research institutions and universities, including Oak Ridge National Laboratory, St. Jude's Research Hospital in Memphis, The University of Tennessee system, Vanderbilt University, and the Arnold Engineering Center in Tullahoma.⁸ Tennessee also has a very strong private-sector medical and health care community in Nashville, and the recent locations and expansions by Dell Computer and other electronic firms has created a great deal of new economic activity in the state. In addition, Tennessee's public and private resources offer entrepreneurs exceptional opportunities to establish start-up companies designed to develop and commercialize new technologies. Despite this fertile environment for new high technology companies, however, Tennessee's traditional economic development programs generally place a major emphasis on offering incentives and subsidies to attract already-existing companies that seek lower costs.⁹

³ ROSS C. DEVOL, MILKEN INSTITUTE, STATE TECHNOLOGY AND SCIENCE INDEX: COMPARING AND CONTRASTING CALIFORNIA 1 (2002), *available at* <http://www.milkeninstitute.org/publications>.

⁴ *Id.* This familiar term is used here to abbreviate the overall economic trend by which it is characterized. *See id.*

⁵ *Id.*

⁶ *Id.*

⁷ ROBERT G. HEARD AND JOHN SIBERT, THE NAT'L GOVERNORS' ASS'N, GROWING NEW BUSINESSES WITH SEED AND VENTURE CAPITAL: STATE EXPERIENCES AND OPTIONS 8 (2000), *available at* http://www.nga.org/center/divisions/1,1188,C_ISSUE_BRIEF^D_621,00.html.

⁸ TENN. TECH. DEV. CORP., THE NEW ECONOMY STRATEGY 3 (2002), *available at* http://www.tennesseeconomy.org/economy_strategy.pdf [hereinafter TTDV NEW ECONOMY].

⁹ Interview with Tom Rogers, Executive Director, Tenn. Tech. Dev. Corp. and President, Technology 2020, in Oak Ridge, Tenn. (Sept. 12, 2002).

More pointedly, several economic indicators suggest that Tennessee is not adequately preparing itself for future growth in the technology sector. Tennessee's efforts towards New Economy initiatives pale in comparison to the efforts of its competitive contiguous states, especially in terms of investment in the economic development of technology-oriented sectors and efforts to strengthen the venture capital infrastructure that supports New Economy companies. Tennessee only recently has begun to focus its efforts towards the emerging technology sectors of the state's economy. The state's technology advocates have identified several technology-related initiatives that would elevate Tennessee's competitiveness in the New Economy:

- (1) expand Tennessee's research and development tax credit program;
- (2) amend Tennessee's job tax credit program to make it more appealing to technology-oriented companies; and
- (3) enact a program that focuses on increasing the availability of venture capital.¹⁰

This Article emphasizes Tennessee's need for a program that increases the availability of venture capital to seed-stage companies and discusses why a qualified investment tax credit program initiative is the most attractive alternative to address this need. This Article also offers statutory language for the proposed Tennessee Seed Capital Qualified Investment Tax Credit program based on a survey and analysis of similar tax incentive programs currently in effect in other states.

Specifically, seed-stage investments "accelerate growth in four key areas: research and development; job creation; state export sales generation; and plant, property, and equipment."¹¹ Generally, "plac[ing] venture capital investments in these areas in the critical years of a company's development enables fast growth that leads to future financial success."¹² Consequently, harnessing entrepreneurial spirit

¹⁰ *Id.*

¹¹ NICOLE R. ONORATO, U.S. SMALL BUSINESS ADMIN., TRENDS IN VENTURE CAPITAL FUNDING IN THE 1990S 11 (1997), *available at* <http://www.sba.gov/advo/stats>.

¹² *Id.*

and capital that “nurture[s]” that spirit should be “a top priority” for policymakers concerned about Tennessee’s local and state economic development.¹³

II. TENNESSEE IN THE NEW ECONOMY

The Tennessee Technology Development Corporation (“TTDC”) recently assessed Tennessee’s economy and concluded that the state’s “overall economy has thrived in recent years.”¹⁴ Specifically, Tennessee has experienced significant growth in private capital investment and new job creation.¹⁵ Much of this growth is due to the Tennessee Department of Economic and Community Development’s efforts in “recruiting and aiding in the expansion of companies primarily in the [state’s] manufacturing sector of the economy.”¹⁶ As a result of these efforts, companies have invested nearly \$40 billion in Tennessee over the last seven years.¹⁷

However, TTDC also concluded that Tennessee is not adequately preparing itself for the New Economy and higher-tech job creation of the future. Tennessee has not kept pace with its competitor states in investing and preparing for the New Economy.¹⁸ Table 1 below illustrates that Tennessee’s neighboring states are investing an average of \$10 million annually on technology while Tennessee’s spending has remained fixed at \$600,000 for four consecutive years.¹⁹

¹³ See HEARD, *supra* note 7, at 9.

¹⁴ TTDC NEW ECONOMY, *supra* note 8, at 3.

¹⁵ *Id.*

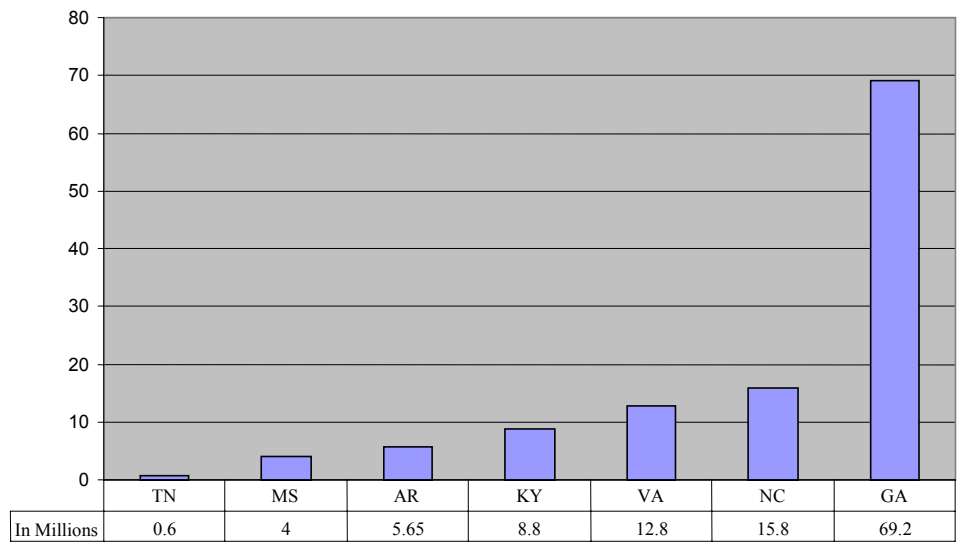
¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.* at 4.

¹⁹ TENN. TECH. DEV. CORP., RECOMMENDATIONS ON SUPPORT FOR THE TENNESSEE TECHNOLOGY DEVELOPMENT CORPORATION PRESENTED TO THE BREDESEN ADMINISTRATION TRANSITION TEAM (2002), *available at* <http://www.tennesseetechnology.org> [hereinafter TTDC RECOMMENDATIONS].

Table 1: 2001 State Technology
 Source: State Technology Development Budgets, State
 Science & Technology Indicators (2001).



The Milken Institute’s New Economy Index (the “Index”) tracks leading indicators such as education attainment, research and development, new business starts, and venture capital investments, to determine states’ readiness to compete in the New Economy.²⁰ The Index ranks Tennessee 33rd in the nation.²¹ Tennessee has actually lost ground in this comparative analysis in the past year, moving from 32nd to 33rd nationally.²² Table 2 below provides a more detailed comparison.

²⁰ DEVOL, *supra* note 3, at 1.

²¹ TTDC NEW ECONOMY, *supra* note 8, at 6.

²² *Id.* at 3.

| Table 2: Tennessee’s Comparative Placement with Contiguous States in The New Economy Index | | |
|---|--|---|
| Index for 1999 and 2000 (latest available information) | Tennessee’s Placement (out of four tiers) | Contiguous States Ranking Higher |
| Rank in the State Technology and Science Index ²³ | 3 rd tier | VA (1 st tier); GA & NC (2 nd tier) |
| R&D inputs ²⁴ | 3 rd tier | GA, NC, & VA (2 nd tier) |
| Risk capital and infrastructure composite ²⁵ | 3 rd tier | GA & VA (1 st tier); NC (2 nd tier) |
| Total venture capital investment growth ²⁶ | 4 th tier | AL (1 st tier); GA, NC, & VA (2 nd tier); KY (3 rd tier) |
| Companies receiving venture capital investment growth ²⁷ | 4 th tier | AL & VA (1 st tier); GA & NC (2 nd tier) |
| Venture capital investment as a percent of gross state product | 3 rd tier | NC & VA (1 st tier); GA & MS (2 nd tier); |

Table 2 illustrates Tennessee’s consistently low placement in the Index’s comparison of technology-based and venture capital expenditures. Tennessee’s contiguous neighbors Georgia, North Carolina, and Virginia consistently place higher than Tennessee. The Index’s economic indicators incorporating technology-

²³ DEVOL, *supra* note 3, at 51. (The State Technology and Science Index “encapsulates a comprehensive inventory of technology and science assets of states that can be leveraged to promote economic development,” and this Index “is composed of five major composites (research & development inputs, risk capital and infrastructure, human capital investment, technology and science workforce, and technology concentration and dynamism.”).

²⁴ *Id.* at 53.

²⁵ *Id.* at 70. (The risk capital and infrastructure attempts “to measure each state’s entrepreneurial culture through the analysis of risk capital vehicles such as venture capital investment and IPO activity.”).

²⁶ *Id.* at 71. (“Venture capital refers to funds invested or available for investment in a new or unproven business endeavor.”).

²⁷ *Id.* at 73. (“Gauging the growth of venture capital investment is a reliable indicator of overall entrepreneurial sentiment in the investment community as well as of its affinity towards risk.”).

based measures illustrate that Tennessee faces a formidable challenge in becoming and remaining competitive in the New Economy.

III. A STRATEGY FOR INCREASING VENTURE CAPITAL IN TENNESSEE

Entrepreneurial companies and talented people will choose to locate in states and communities that can provide a supportive environment for their endeavors.²⁸ Only those states that have the ability to offer a comprehensive support system will thrive in the New Economy.²⁹ Tennessee arguably already has in place several of the key elements necessary to support emerging technology-based enterprises: (1) governmental and institutional technology transfer programs such as The University of Tennessee and the Oak Ridge National Laboratory, (2) a network of small business development centers, (3) state sponsored economic development entities, such as TTDC and Technology 2020, that focus on technology, and (4) venture capital funds, such as the TennesSeed Fund, that focus on technology-based enterprises. Despite these positive attributes, Tennessee lacks a comprehensive program that focuses on increasing the availability of venture capital to the state's emerging seed-stage enterprises.

Average growth companies require \$12 million of equity capital to survive their first five years,³⁰ and venture capital is a primary source of equity capital for growth companies "in areas such as technology, research, computer-related enterprises, biotechnology, and other science-based fields."³¹ Venture capital has emerged as the primary form of financing because these companies "typically do not have the operating history or tangible assets required to obtain capital from more traditional sources, such as banks and the public debt and equity markets"³²

²⁸ See TTDC RECOMMENDATIONS, *supra* note 19.

²⁹ *Id.*

³⁰ See G. BROOK ADAMS, THE N.C. COUNCIL FOR ECON. DEV., THE SHORTAGE OF EARLY STAGE CAPITAL FOR EMERGING HIGH-GROWTH COMPANIES IN NORTH CAROLINA 1 (1996).

³¹ Laura A. Tomaka, *Bolstering Investment in Venture Capital Seen as Way to Boost Slumping Economies*, 9 FIRSTLINE MIDWEST, Apr. 2002, at 1 (sponsored by the Midwestern Office of the Council of State Gov'ts), available at http://www.csgmidwest.org/member_services/flmw/2002/0402.pdf.

³² JUSTIN COOK & SEAN NEVINS, THE ZERMATT GROUP, THE 1999 ARIZONA VENTURE CAPITAL IMPACT STUDY, 8 (1999), available at <http://www.zermattgroup.com/publications/1999AVCIS.pdf>.

However, traditional venture capital funds are “incompatible” with seed- and early-stage businesses for several reasons: “the limited size of early-round investments, modest future anticipated needs [of the entities], or a higher risk profile associated with limited information on market potential” for new technologies.³³ Due to these higher inherent risks at the seed capital stage, traditional venture capital focuses on further-developed companies.³⁴ Yet, seed- and early-stage businesses must make expensive investments in facilities, staffing, equipment, research and development, and intellectual property protection in order to launch their businesses.³⁵ It is customary for these businesses to have little, if any, sales and to have negative cash flow because their products are still in development.³⁶ Consequently, an equity gap exists between initial start-up funds, generally an entrepreneur’s savings and funds raised from friends and family, and later rounds of financing from traditional venture capital firms. In other words, this equity gap is “the difference between the smaller size investments that seed-stage companies need and the minimum investments that venture capitalists or investment banks are willing to make.”³⁷

Ideally, angel investors “ease the equity gap” by investing “their personal capital in new and existing firms in return for equity.”³⁸ Most “angel investments are high-risk, early-stage entrepreneurial ventures.”³⁹ Angel investors provide capital at the very earliest concept stage and take a much greater risk than banks because they generally do not require collateral for their investment.⁴⁰ Angel investors are the primary funding resource for entrepreneurial endeavors under \$500,000 and, indeed,

³³ See DEVOL, *supra* note 3, at 17.

³⁴ Interview with Don Welty, President, Southeast Comty. Capital Corp. and Fund Manager, TennesSeed Fund, in Oak Ridge, Tennessee (Oct. 2002).

³⁵ See ADAMS, *supra* note 30.

³⁶ *Id.*

³⁷ RICHARD LEAZER & STEPHEN Z. ROYKO, SEED AND VENTURE CAPITAL FORMULATION: ESSENTIAL TO HIGH-TECH BUSINESS JOB GROWTH 5 (2000) (prepared for the Wisconsin Economic Summit).

³⁸ *Id.* at 4-5.

³⁹ *Id.* at 4.

⁴⁰ DEVOL, *supra* note 3, at 17.

often are the only funding resource for start-up businesses,”⁴¹ providing “[84%] of the early-stage investments under \$250,000 and [58%] of investment between \$250,000 and \$500,000.”⁴² In short, angel investors provide seed-stage businesses a valuable “bridge to venture capital firms” by enabling them to prove their technological concept and strengthen their organization.⁴³

Across the county, “[p]olicymakers who want to facilitate innovation and foster an entrepreneurial climate within their states are seeking ways to increase the availability of venture capital.”⁴⁴ Several states have recognized the important role of seed- and early-stage venture capital in a state’s overall economic development and have enacted legislation encouraging this type of investment activity.⁴⁵ In line with the general trend, these states encourage “risk taking and minimizing its negative impact.”⁴⁶

One of these strategies is a state-sponsored qualified investment tax credit program, alternatively called an angel investor tax credit program. This type of program encourages angel investors to invest in certain preferred businesses by providing a state income tax credit in an amount equal to a defined percentage of the angel investor’s investment amount. These programs typically address the financing needs of the respective state’s small businesses. A qualified investment tax credit program in Tennessee will enable the state to indirectly address equity gaps by encouraging individuals to directly invest in the state’s seed-stage businesses, thereby increasing the availability and accessibility of seed venture capital. A qualified investment tax credit program also has secondary benefits, including (1) the generation of wealth through more jobs; (2) increased economic activity vis-à-vis additional sales and capital infusion into the state economy, thereby benefiting Tennessee businesses; and (3) the reinforcement of Tennessee’s long-term commitment to supporting and promoting high-growth industries of the New Economy.

⁴¹ See ADAMS, *supra* note 30.

⁴² LEAZER, *supra* note 37, at 5 (*citing* MARK VAN OSNABRUGGE & ROBERT ROBINSON, ANGEL INVESTING: MATCHING START-UP FUNDS WITH START-UP COMPANIES (2000)).

⁴³ LEAZER, *supra* note 37, at 5.

⁴⁴ Tomaka, *supra* note 31, at 1.

⁴⁵ See *infra* Appendix II.

⁴⁶ Tomaka, *supra* note 31, at 1.

IV. PROPOSED TENNESSEE QUALIFIED INVESTMENT TAX CREDIT PROGRAM

67-2-130. Seed Capital Qualified Investment Tax Credit; definitions.

As used in this chapter, unless the context otherwise requires:

1. “Family Member” is a spouse, child, grandchild, parent, spouse’s parent, or grandparent.
2. “Net State Income Tax Liability” is a taxpayer’s state income tax liability under § 67-2-102 reduced by all other credits and exemptions defined by § 67-2-104.
3. A taxpayer “Participates in the Operation of a Qualified Business” if the taxpayer, the taxpayer’s Family Members, or an employee of any of these individuals, provides services of any nature to the Qualified Business for compensation, whether as an employee, a contractor, or otherwise. However, a person who provides services to a Qualified Business as an officer, board member, or otherwise does not participate in its operations if the individual receives as compensation only reasonable reimbursement of expenses incurred in providing the services, participation in a stock option or stock bonus plan, or both.
4. “Principal Owner” is one who (a) participates in the control of the business and who, together with others, owns 50% or more of the eligible business or (b) participates in the management of the business on a full-time basis.
5. “Qualified Business” is a business that:
 - (a) is located in Tennessee;
 - (b) is formed as a corporation, partnership, or limited liability company and is in good standing and authorized to do business in the state;
 - (c) operates in a Qualified Trade or Business;
 - (d) is the full-time, professional activity of at least one of the Principal Owners;
 - (e) is fewer than three years old as of the date of application as a Qualified Business;
 - (f) has annual gross sales of \$3 million or less; and

(g) has not received an aggregate amount of Qualified Investments in excess of \$600,000.

6. “Qualified Investment” is a cash investment that meets the following criteria:

(a) The investment purchases the equity securities of a Qualified Business;

(b) The purchase of the equity securities is not subject to a broker’s fee or commission or other similar remuneration paid or given directly or indirectly for solicitation of the purchase;

(c) The investment is made under an agreement where the Qualified Business may not repay the investment to the taxpayer within two years of the date in which the Qualified Business receives the investment proceeds;

(d) The investment must remain entirely at risk of loss and repayment of principal, and any return must depend entirely upon the success of the Qualified Business;

(e) The Qualified Business must expend the entire proceeds of the investment for plant, equipment, research and development, marketing and sales activity, or working capital for the business;

(f) The taxpayer’s aggregate Qualified Investments in one or more Qualified Businesses do not exceed \$200,000 per year; and

(g) The taxpayer’s cumulative Qualified Investments in any one Qualified Business do not exceed \$200,000.

A Qualified Investment does not include existing investments that have been purchased, transferred, or otherwise obtained without providing new capital to a Qualified Business.

7. “Qualified Trade or Business”

(a) A Qualified Trade or Business is any trade or business that primarily involves (i) Research and Development, Technology Transfer, biotechnology, information technology, or the application of new technology developed through Research and Development or acquired through Technology Transfer or (ii) any trade or business that brings significant capital into Tennessee. In determining whether a business brings new capital

into the state, the administrator will consider whether the investment will (i) create jobs within the state, (ii) produce sales tax revenue for the state, and (iii) result in new capital being brought into the state in an amount at least equal to the amount of the corresponding credit sought under this chapter within two years of the granting of the credit.

(b) A Qualified Trade or Business does not include:

(1) Any trade or business involving the performance of services in the field of law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial or 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; or

(2) Any banking, insurance, financing, leasing, rental, investing, or similar business; or

(3) A real-estate-related business. A business that is involved in or related to the brokerage, selling, purchasing, leasing, operating, or managing of hotels, motels, nursing homes or other lodging facilities, golf courses, sports or social clubs, restaurants, storage facilities, or commercial or residential lots or buildings is a real estate-related business. A real-estate-related business does not include (i) a business that purchases or leases real estate from others for the purpose of providing itself with facilities from which to conduct a business that is not itself a real-estate-related business or (ii) a business that is not otherwise a real-estate-related business but that leases, subleases, or otherwise provides to one or more other persons a number of square feet of space that, in the aggregate, does not exceed 50% of the number of square feet of space occupied by the business for its other activities.

8. “Research and Development” means designing, creating, or formulating new or enhanced products, equipment, or processes and conducting scientific or technological inquiry and experimentation in the physical sciences with the goal of increasing scientific knowledge that may reveal the basis for new or enhanced products, equipment, or processes.

9. “Technology Transfer” means the transfer of technology from one sector of the economy to another, including the transfer of military technology to civilian

applications, civilian technology to military applications, or technology from public or private research laboratories to military or civilian applications.

67-2-131. Seed Capital Qualified Investment Tax Credit; general credit provisions.

For taxable years beginning on or after January 1, 2004, a taxpayer shall be allowed a credit against the taxpayer's Net State Income Tax Liability in an amount equal to 25% of the taxpayer's Qualified Investments. The aggregate amount of credit that a taxpayer may claim per taxable year under this chapter shall not exceed 50% of the taxpayer's Net State Income Tax Liability.

The total amount of tax credits available under this chapter for Qualified Investments made on or after January 1, 2004, but before January 1, 2005, shall not exceed \$3,000,000. The total amount of newly available tax credits under this chapter for each calendar year beginning on or after January 1, 2005, shall not exceed \$4,000,000. In the event that taxpayers do not request the total available tax credits in a given year, the administrator shall add any remaining available tax credits to the subsequent year's newly available tax credits.

67-2-132. Seed Capital Qualified Investment Tax Credit; Qualified Business application procedure.

The administrator shall be responsible for developing a Qualified Business application, making the applications available to businesses, and assisting businesses in preparing the applications. The application shall include at a minimum (1) general information identifying and describing the business, (2) the business's gross annual sales for the preceding year, (3) the business's formation date, and (4) the intended use of any Qualified Investment proceeds. The administrator shall not issue a tax credit certificate to a taxpayer corresponding to an investment into a business before the administrator's receipt of the business's Qualified Business application.

A business shall file with the administrator an application, a business plan, a \$200 nonrefundable fee, and any other information the administrator may require. The administrator, within four weeks of receiving a completed application, shall determine whether the business is a Qualified Business and shall promptly send the business either a Qualified Business certificate or written notice of the reasons the business does not meet the Qualified Business criteria.

Each Qualified Business that receives a Qualified Investment shall file an annual report with the administrator no later than January 31 of each subsequent year that the business is certified as a Qualified Business. This report shall include (1) whether the applicant is a minority-owned business, (2) the number of jobs the business created during the preceding year, (3) the average wages paid, and (4) the preceding calendar year's gross revenues. In the event that a Qualified Business fails to meet the program's reporting requirements, the administrator shall revoke the Qualified Business certification and rescind the tax certificates attributable to the Qualified Investments made during the calendar year for which the report is required until the administrator receives the report. If the administrator does not receive the Qualified Business's annual report by March 31, the administrator shall notify the Department of Revenue regarding the rescinded tax credit certificates.

The administrator deems a Qualified Business that exceeds \$3,000,000 in annual sales no longer eligible as a Qualified Business for the subsequent year. A business may re-apply as a Qualified Business in the following year if its gross sales fall below \$3,000,000 and the business is fewer than three years old at the time of re-application.

A Qualified Business may sell or otherwise transfer its Qualified Business certificate only if it enters into a merger, conversion, consolidation, or other similar transaction with another business and the surviving company otherwise meets the Qualified Business criteria.

67-2-133. Seed Capital Qualified Investment Tax Credit; tax credit application procedure.

The administrator shall be responsible for developing a taxpayer application, making the applications available to taxpayers, and assisting taxpayers in preparing the applications. Only natural persons may claim the credits provided under this chapter. Natural persons ineligible to claim the credit include:

- (a) A Principal Owner or a spouse of a Principal Owner of a Qualified Business;
- (b) A Family Member of a Principal Owner if the person has any existing ownership interest in the Qualified Business;
- (c) A taxpayer, or any of the taxpayer's Family Members or any entity affiliated with the taxpayer, that receives or has received compensation from the Qualified Business in exchange for services provided to the business as

an employee, officer, director, manager, consultant, independent contractor, or otherwise in connection with or within one year before or after the date of the taxpayer's Qualified Investment; and

(d) A taxpayer who participates in the operation of the Qualified Business within two years of the Qualified Investment date.

Eligible taxpayers shall file an investor application accompanied by a \$100 nonrefundable fee with the administrator. The administrator shall review the investor's application within four weeks after the submission of a completed application and shall issue a formal approval of tax credit status or reject the application. After receiving notice of approval from the administrator, a taxpayer, within a period of time determined by the administrator, may make the investment and may apply to the administrator for a tax credit certificate.

67-2-134. Seed Capital Qualified Investment Tax Credit; issuance and use of tax credit certificates.

Upon the administrator's satisfaction that the taxpayer has made the investment in the proper form, the administrator shall issue the taxpayer a tax credit certificate indicating the allowable credit amount. Taxpayers may claim the allowable credit amount on the tax return applicable to the taxable year in which the taxpayer made the Qualified Investment. In the event that the allowable credit amount exceeds 50% of the taxpayer's Net State Income Tax Liability, the taxpayer may claim any unused portion of the credit in the subsequent tax year for a period of up to seven years. A taxpayer shall combine any carry forward amount with all available credit amounts before applying the 50% Net State Income Liability test. The Department of Revenue shall establish guidelines taxpayers must follow to claim the allowable credit amount.

In the event that taxpayers request credits in excess of the available credits, the administrator shall grant each taxpayer a prorated share of the available credits. The administrator shall base this allocation on timely filed applications and will not subsequently adjust the allowable amounts for credits applied for but not subsequently claimed by taxpayers. In the event of an allocation, the administrator shall notify the taxpayer of the amount of the reduction of allowable credit on or before January 31 of the year following the calendar year of the Qualified Investment date.

67-2-135. Seed Capital Qualified Investment Tax Credit; revocation of tax credit certificate.

A taxpayer shall recapture any previously claimed credits and forfeit any remaining unclaimed tax credit in the following events:

- (a) The administrator revokes the certification as a Qualified Business because information in the registration application was false at the time the business filed the application;
- (b) The taxpayer materially participates in the operations of the Qualified Business within two years of the investment date;
- (c) The Qualified Business makes a redemption with respect to the securities received for the Qualified Investment within two years of the investment date; or
- (d) The taxpayer transfers any of the securities received in the Qualified Investment within two years of the investment date.

The Department of Revenue may impose any applicable interest and penalties on the recaptured credits. The taxpayer must also pay the Department of Revenue a penalty in the amount of 25% of the total allowable credit amount stated on the tax credit certificate.

67-2-136. Seed Capital Qualified Investment Tax Credit; holding period and allowable return on Qualified Investment.

A taxpayer may not transfer any of the securities received for a Qualified Investment within two years after the investment date. Exceptions to this holding requirement include a transfer resulting from (1) the death of the taxpayer, (2) a final distribution in liquidation to the owners of a Qualified Business that is a corporation or other entity, or (3) a merger, conversion, consolidation, or similar transaction requiring approval by the owners of the Qualified Business under applicable state law to the extent that the taxpayer does not receive cash or tangible property in the transaction.

A Qualified Business may not make repayments to the taxpayer except for dividends during the two-year period following the investment date. This limitation does not limit the return on investment in the form of dividends that a taxpayer may receive during a Qualified Investment's required holding period.

67-2-137. Seed Capital Qualified Investment Tax Credit; administrator disclaimer and reporting requirements.

The administrator does not endorse a business or the prudence of an investment by certifying a Qualified Business or by issuing tax credit certificates. The administrator does not review the financial or business prospects of any business or review or approve any materials used by the Qualified Business to solicit Qualified Investments.

The administrator shall notify the Department of Revenue regarding any revocation or disallowances of tax credit certificates. The administrator shall maintain a publicly accessible list of Qualified Businesses. The list shall include each Qualified Business's name, addresses, and the nature of the business.

The administrator and the Department of Revenue shall each issue an annual report to the Tennessee Department of Economic and Community Development and to the General Assembly regarding the activity under this chapter. The respective reports shall reflect both the annual and cumulative figures for each line item.

The administrator shall issue its annual report by the first business day of the third month following each calendar year. The report shall include the following information:

- (a) The number of entities applying for certification as a Qualified Business;
- (b) The number of entities certified as a Qualified Business;
- (c) The names and addresses of the entities certified as a Qualified Business;
- (d) The number of individuals applying for the tax credit;
- (e) The number of tax credit certificates issued;
- (f) The amount of tax credit certificates issued;
- (g) The number of investments made by taxpayers;
- (h) The amount of investments made by taxpayers;
- (i) The number of Qualified Businesses receiving Qualified Investments;

(j) The number of jobs created by Qualified Businesses receiving Qualified Investments; and

(k) The average amount of wages paid by these new jobs.

The Department of Revenue shall issue its report by October 1 of each year. The Department's report shall include the following information:

(a) The number of taxpayers claiming the tax credit; and

(b) The amount of credits claimed by taxpayers.

V. EXPECTED PERFORMANCE OF THE PROPOSED PROGRAM

This discussion of the proposed program's expected performance bases its projections on the following assumptions: (1) the program will provide available tax credits in the amount of \$3,000,000 in the program's initial year and in the amount of \$4,000,000 in each subsequent year; (2) the percentage of a qualified investment eligible for the credit is 25%; (3) taxpayers will request the maximum available credits each year; and (4) each qualified investment is in the maximum amount of \$200,000.

The \$3,000,000 in available credits corresponds to \$12,000,000 in taxpayers' qualified investments into qualified businesses.⁴⁷ The \$4,000,000 in available credits for each subsequent year corresponds to \$16,000,000 in qualified investments.⁴⁸ Thus, the total amount of available tax credits during the program's first five years is \$19,000,000, and this amount corresponds to \$76,000,000 in qualified investments over five years.

Maximum participation in the program will result in a minimum of 20 qualified businesses receiving qualified investments in program's initial year and 26 qualified businesses receiving investments in each subsequent year.⁴⁹ Under this scenario, the administrator will collect a minimum of \$4,000 in qualified business

⁴⁷ See *infra* Appendix V. If taxpayers make \$12,000,000 worth of qualified investments in qualified business and if 25% of that investment is eligible for the credit, \$3,000,000 will be eligible for the credit.

⁴⁸ See *id.*

⁴⁹ See *id.* (assuming that each qualified business receives three qualifying investments in the amount of \$200,000).

application fees in the program's initial year and \$5,200 in each subsequent year.⁵⁰ For the initial five-year projected period, a minimum of 98 qualifying business will have received qualified investments.⁵¹ The program requires that the qualified businesses use these investments proceeds towards the fiscal and operational needs of the business, and qualified business theoretically will use these funds throughout the state for the purchase of plants and equipment, job creation, and working capital.

Maximum participation in the program will result in the administrator issuing a minimum of 60 tax credit certificates in the program's initial year and 80 tax credit certificates in each subsequent year.⁵² However, the number of taxpayers requesting tax credit certificates will increase in years when each taxpayer does not invest the maximum \$200,000 qualified investment amount but, in the aggregate, taxpayers request the entire amount of available credits in a given year. The administrator will collect a minimum of \$6,000 in taxpayer application fees in the program's initial year and \$8,000 in each subsequent year.⁵³

A. Impact on State Revenues

The program's impact on the state's revenue collections is unknown. However, the decrease in the state's revenue collections should not exceed \$3,000,000 for the year following the program's initial year and \$4,000,000 for the fiscal years thereafter.⁵⁴

B. Additional Costs to the State

Additional costs to the state attributable to the administration of the program depend on the state's funding to the program administrator. If the state's overall budget includes increases for the administrator's general operations, then the

⁵⁰ *See id.* (calculated by multiplying the minimum number of qualified businesses receiving investment (20 in the program's initial year and 27 for each subsequent year) by the applicable application fee (\$200)).

⁵¹ *See id.*

⁵² *See id.* (assuming that each taxpayer invests the \$200,000 maximum qualified investment amount).

⁵³ *See id.* (calculated by multiplying the minimum number of tax credit certificates issued (60 in the program's initial year and 80 for each subsequent year) by the applicable application fee (\$100)).

⁵⁴ Because Tennessee's fiscal years end June 30, tax credits claimed for qualified investments made during calendar year 2004 will impact revenue collections for the fiscal year ending June 30, 2005.

administrator may not require additional funding specifically for administering the program.⁵⁵ However, if the administrator's current state-funding level is not adequate to sustain the administrator's increased costs related to the program, then the state will have to provide additional funding specifically for the program's administration.

The Tennessee Department of Revenue will incur costs attributable to the proposed program, including costs associated with systems development, but these costs cannot be ascertained at this time. However, the Department of Revenue likely is able to absorb these administrative costs within its existing budgeted resources.

C. Cost to Tennessee's Cities and Counties

The proposed program will have a direct financial impact on Tennessee's cities and counties due to the state's distribution formula of the Hall income tax⁵⁶ collections between the State's general fund and the State's cities and counties.⁵⁷ When the General Assembly enacts the proposed program, it must simultaneously amend Tennessee Code Annotated section 67-2-119, which dictates the disposition of Hall income tax collections to account for the program's potential localized costs to the state's cities and counties.⁵⁸

⁵⁵ Interview with Tom Rogers, *supra* note 9.

⁵⁶ TENN. CODE ANN. § 67-2-102 (2002). Tennessee's income tax generally is referred to as the "Hall income tax."

⁵⁷ See *infra* Appendix I. Specifically, subsection A discusses the distribution of Hall income tax collections and the proposed credit's impact on the state's cities and counties.

⁵⁸ See *id.*; see generally TENN. CODE ANN. § 67-2-119.

APPENDIX I. FACTORS CONSIDERED IN DEVELOPING A PROGRAM FOR TENNESSEE

The overriding objective of the proposed Tennessee Seed Capital Qualified Investment Tax Credit program is to promote economic development throughout the state of Tennessee. The program attempts to meet this objective by focusing on the equity financing needs of Tennessee’s seed-stage businesses that have the greatest potential to bring new capital into the state and to create new, higher-tech, higher-paying jobs. The program’s goal is to encourage individuals in Tennessee to invest private capital in these businesses, thereby increasing the availability and accessibility of seed venture capital. This seed capital will enable qualified businesses to develop to a point where they can arrange more traditional financing from banks and venture capital funds.

A. Tennessee’s Income Tax Structure

The state programs surveyed below in Appendix II provide taxpayers with a credit that the taxpayers may claim as a direct offset against their respective state income tax liability. However, Tennessee limits its state income tax to dividends and interest income⁵⁹ and is one of only two states that does so.⁶⁰ As a result, a Tennessee taxpayer’s individual state income tax liability generally is lower than a comparable taxpayer residing in a state that provides a similar qualified investment tax credit program. Table 3 compares the 2001 per capita individual state income tax liability of Tennessee with the states surveyed in Appendix II.

| Table 3: 2001 Per Capita Individual State Income Tax Liability | | | | | | |
|---|-------|----------------|--------------|-------|-----------|----------|
| Iowa | Maine | North Carolina | North Dakota | Ohio | Tennessee | Virginia |
| \$646 | \$903 | \$919 | \$336 | \$804 | \$35 | \$1,005 |
| Source: U.S. Census Bureau | | | | | | |

Generally, any person whose legal domicile is in Tennessee and whose taxable interest and dividend income exceeds \$1,250 (\$2,500 if married and filing

⁵⁹ See TENN. CODE ANN. § 67-2-102.

⁶⁰ See N.H. REV. STAT. ANN. § 77:3 (LEXIS 2002).

jointly) must file a Tennessee income tax return.⁶¹ All taxable dividends and interest income in excess of \$1,250 for individual filers or \$2,500 for those married and filing jointly are taxable at the rate of 6%.⁶² Tennessee’s income tax collections for fiscal years 1999 through 2002 are provided below in Table 4.

| Fiscal Year | Amount |
|---|---------------|
| 2002 | \$146,293,414 |
| 2001 | \$198,071,186 |
| 2000 | \$180,277,750 |
| 1999 | \$160,179,906 |
| Source: Tennessee Department of Revenue | |

B. Costs to Cities and Counties

A credit against the Hall income tax has a direct effect on the cities and counties across the state. The Department of Revenue distributes the Hall income tax collections as follows: (1) five-eighths is paid into the general fund of the state treasury and (2) the remaining three-eighths is distributed among the State’s cities and counties of the state.⁶³ The amount distributed to the cities and counties is allocated as follows: (1) “where a taxpayer residing within the corporate limits of any municipality pays [the Hall income tax], then three-eighths of the net tax collected from the taxpayer is returned to the city within which the taxpayer resides,”⁶⁴ and (2) “where a taxpayer residing in a county, but outside the corporate limits of any municipality, pays [the Hall income tax], then three-eighths of the net tax collected from the taxpayer is returned to the county within which the taxpayer resides.”⁶⁵ Table 5 illustrates the distribution of the Hall income tax collections for fiscal years 1999 through 2002.

⁶¹ See TENN. CODE ANN. §§ 67-2-104(a) (exempting the first \$1,250 of income for individuals (or \$2,500 married couples filing jointly) from the Hall income tax) & 67-2-107(a) (requiring the filing of a return).

⁶² *Id.* §§ 67-2-104(a) & 67-2-102. Section 67-2-104 contains additional exemptions mentioned later. See generally TENN. CODE ANN. §§ 67-2-104.

⁶³ *Id.* § 67-2-119(a).

⁶⁴ *Id.* § 67-2-119(b).

⁶⁵ *Id.* § 67-2-119(c).

| Fiscal Year | TN Dept of Revenue Income Tax Collections ^(a) | Distributed to the General Fund ^(b) | Distributed to Cities and Counties ^(c) |
|-------------|--|---|--|
| 2002 | 146,293,414 | 91,433,384 | 54,860,030 |
| 2001 | 198,071,186 | 123,794,491 | 74,276,695 |
| 2000 | 180,277,750 | 112,673,594 | 67,604,156 |
| 1999 | 160,179,906 | 100,112,441 | 60,067,465 |

^(a) Source: Tennessee Department of Revenue
^(b) Calculated by multiplying the Income Tax Collections by five-eighths.
^(c) Calculated by multiplying the Income Tax Collections by three-eighths.

The small municipality of Belle Meade, located outside of Nashville, Tennessee, illustrates the financial impact of Hall income tax collections. The distribution of the collections to Belle Meade represents more than one-third its annual budget.⁶⁶ However, a resident taxpayer claiming the proposed credit consequently will reduce the city's Hall income tax distribution amount. For example, assuming that a taxpayer may claim a maximum annual credit in the amount of \$50,000, each Belle Meade resident taxpayer claiming the credit will reduce the city's Hall income tax distribution share by \$18,750.⁶⁷ This reduction can have a significant impact on a small municipality or county when multiple resident taxpayers claim the credit. Therefore, the most equitable solution is to apply the credits redeemed under the proposed program directly against the state's general fund.

C. Program Administration

Other states have delegated administration of their respective qualified investment tax credit program to either their respective department of taxation or an independent state agency. The Tennessee General Assembly has the option to delegate the program's administration to the Tennessee Department of Revenue, one of the state's several non-profit organizations that receive state funding, or to an

⁶⁶ Associated Press, *Hall Tax Provides Millions To Local Governments*, (Feb. 25, 2002), available at <http://www.oakridger.com/stories>.

⁶⁷ This figure is the product of \$50,000 and three-eighths, the portion of a city's share under Tenn. Code Ann. § 67-2-119(b).

independent state agency. Ideally, administration of the program furthers the mission of any entity seeking appointment as program administrator.

A prospective program administrator should have an established network that can provide exceptionally cost-efficient and effective methods to market and administer the program. An administrator's network of affiliates could spread the administrative costs over several state-sponsored and independent agencies without the need for a significant increase, if any, in the respective agencies' budgeted resources.⁶⁸ An example component of this network would be a relationship with Tennessee's Small Business Development Center ("SBDC"). The Tennessee SBDC is partially funded under a cooperative agreement by the U.S. Small Business Administration in partnership with the Tennessee Board of Regents, and it provides free assistance to help business owners grow and develop successful businesses.⁶⁹ The Tennessee SBDC has ten full-service business centers across Tennessee and several smaller affiliate offices.⁷⁰

One example of a prospective program administrator is the Tennessee Technology Development Corporation (abbreviated above as "TTDC"). TTDC is presented as a prospective administrator only for discussion purposes and is based on this author's familiarity with the organization. There are several independent and state entities that the General Assembly may appoint as the program's administrator, and it is intended that these organizations effectively compete for the position.

TTDC is a federal-income-tax-exempt Tennessee nonprofit corporation headquartered in Oak Ridge, Tennessee.⁷¹ The Tennessee General Assembly created TTDC in 1998 "to forge Tennessee's role in the New Economy."⁷² TTDC's mission is to establish and grow companies from the state's technology resources.⁷³ TTDC focuses its efforts on "supporting and fostering entrepreneurship and leadership,"

⁶⁸ Interview with Tom Rogers, *supra* note 9.

⁶⁹ Interview with Dan Collier, Tennessee Small Business Development Center, in Oak Ridge, Tennessee (Oct. 17, 2002).

⁷⁰ *Id.*

⁷¹ Tenn. Tech. Dev. Corp., *History* Page, at <http://www.tennesseeotechnology.org/history.html> (last visited May 7, 2003).

⁷² *Id.*

⁷³ Interview with Tom Rogers, *supra* note 9.

“improving access to capital,” “building and improving on technology commercialization efforts,” and “connecting ideas, people, and resources.”⁷⁴

TTDC also has an extensive network of affiliates, including the Tennessee SBDC. TTDC is closely affiliated with Technology 2020, also a federal-income-tax-exempt Tennessee nonprofit corporation headquartered in Oak Ridge, Tennessee.⁷⁵ Technology 2020’s mission is to leverage Tennessee’s unique technological resources to foster new businesses, create private sector jobs, and improve Tennessee’s prospects for future economic growth.⁷⁶ Technology 2020 established its Business Development Program to help companies meet the challenges associated with business start-up and to develop them into successful Tennessee companies, and it provides incubator facilities and business mentors.⁷⁷

Technology 2020 wholly controls Southeast Community Capital Corporation (“SCC”) and created SCC in 1999 “as part of a statewide effort to increase capital to small businesses in Tennessee.”⁷⁸ SCC provides loans and investments to small businesses in low-income areas throughout Tennessee that do not have access to traditional financing options, and it also provides technical assistance for enhancing business planning, marketing, management, financial management, and entrepreneurial skills to these small business owners.⁷⁹ SCC also is the management company for Southeast Capital Partners, L.P. (formerly the TennesSeed Fund I, L.P.) and controls 50% of the management company of the Southern Appalachian Fund.⁸⁰ SCC has offices in Oak Ridge, Chattanooga, Nashville, and Memphis.⁸¹

⁷⁴ Tenn. Tech. Dev. Corp., *History Page*, at <http://www.tennessee2020.org/history.html> (last visited May 7, 2003).

⁷⁵ See Technology 2020, *History page*, at <http://www.tech2020.org/overview/history.php> (last visited May 7, 2003).

⁷⁶ *Id.*

⁷⁷ See Technology 2020, *Business Development & Incubation page*, at <http://www.tech2020.org/incubation/overview.php>.

⁷⁸ See Technology 2020, *Southeast Community Capital page*, at <http://www.tech2020.org/finance/overview.php>.

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ *Id.*

D. Percentage of a Qualified Investment Eligible for the Tax Credit

The program’s intent is to provide an incentive for a taxpayer to make a qualified investment, not to subsidize an investment. A dollar for dollar tax credit provides a taxpayer a guaranteed return of investment in the form of a credit against the taxpayer’s state income tax liability in addition to any return on investment. A 100% credit amount reduces an investment’s risk of loss and may induce investments in companies that may not otherwise contribute to the program’s mission of economic development. Therefore, the percentage of a qualified investment that is eligible for a tax credit must be below 100%. Below, Table 6 summarizes the percent of qualified investments eligible for a tax credit of the states surveyed in Appendix II.

| Iowa ⁸² | Maine ⁸³ | North Carolina ⁸⁴ | Ohio ⁸⁵ | Virginia ⁸⁶ |
|--------------------|---------------------|------------------------------|--------------------|------------------------|
| 20% | 40% | 25% | 25% | 25% |

The performances of the programs of the states surveyed in Appendix II indicate that a tax credit in the amount of 25% of a qualified investment provides an incentive for taxpayers to participate in the program. A 25% credit eliminates the risk of total loss but still requires taxpayers to depend on the success of the business for a return of investment. Taxpayers must continue to scrutinize investment opportunities in search of companies that possess the greatest potential for an attractive return on investment. Consequently, Tennessee indirectly is ensuring that the businesses receiving qualified investments are the businesses possessing the greatest potential to provide a return to the state in the form of new jobs and an increased revenue base.

⁸² 2002 Iowa Acts 15E.43.

⁸³ ME. REV. STAT. ANN. tit. 10, §§ 1100-T.2.A & 2-A.A (West 2002).

⁸⁴ N.C. GEN. STAT. § 105-163.011(b) (2002).

⁸⁵ OHIO REV. CODE ANN. § 122.15.2(A) (Anderson 2003).

⁸⁶ Currently, Virginia’s credit is worth 50% of an individual’s qualified investment. VA. CODE ANN. § 58.1-339.4(B) (Michie 2003). The figure used here and throughout this Article, 25%, is based on a proposed amendment to the current statute. *See* H.R. 2466, 2001 Gen. Assem., Reg. Sess. (Va. 2001).

E. Available Tax Credits

1. Aggregate Available Credits Under the Program

The Tennessee General Assembly has several options in structuring the program's aggregate available tax credits. The following describes the two predominate models of the states surveyed in Appendix II and certain advantages and disadvantages of each model.

- (1) Establish the program's aggregate available credits without limiting the annual available credits and re-evaluate the program once taxpayers reach the aggregate limit.⁸⁷
 - The program's lifespan is uncertain.
 - Annual impact on state revenues is uncertain, and there is a risk that taxpayers may exhaust program's available tax credits in a short period of time.
 - However, taxpayers are assured that they may claim the entire allowed credit amount in a taxable year, subject to a prorated credit only in the year that taxpayer requests reach the program's aggregate limit; and
 - Legislative action is not necessary unless and until taxpayers reach the program's aggregate limit.
- (2) Establish a perpetual, annual amount of available credits without establishing an aggregate total of available credits.⁸⁸
 - The legislature has flexibility to adjust the annual amount of available tax credits.
 - The program does not have a sunset date.

⁸⁷ See, e.g., *infra* Appendix II, Part C. (discussing Ohio's investment tax Credit program).

⁸⁸ See, e.g., *infra* Appendix II, Part B. (discussing North Carolina's tax credits for qualified business investments).

- Taxpayers are subject to potential pro rated allowable credit amounts in years that taxpayers request credits in excess of the year's available credits; and
- Susceptible to budget cuts and legislative whims – Legislature could reduce or eliminate the amount of credits in years of extreme budget constraints despite the program's success, Legislature could discontinue the program prematurely before adequate information is available to evaluate the program's performance.

The proposed program establishes the aggregate available tax credits on an annual basis. The program is perpetual until the General Assembly discontinues the program. This model allows the General Assembly to adjust the available tax credits according to the availability of state funds and to the success of the program. This model also provides a definitive figure regarding the program's fiscal impact on the state's revenue collections.

2. Annual Amount of Available Credits

Tennessee's current budget constraints are a significant factor in determining the amount of available tax credits under the proposed program. As an illustration, Virginia recently amended its program to increase the amount of available credits per year to \$20,000,000.⁸⁹ However, Virginia's budget constraints required the governor to reduce the amount of available credits to \$4,000,000 for 2002.⁹⁰ Iowa's budget constraints also affected its program. Iowa deferred its program's impact on the fiscal budget by delaying a taxpayer's ability to claim a credit until three years after the date of a qualified investment.⁹¹

Taxpayers participating in the programs surveyed in Appendix II requested an average of approximately \$4,241,493, \$7,013,651, and \$5,273,006 in tax credits in years 1999, 2000, and 2001, respectively.⁹² For discussion purposes, this Article

⁸⁹ See *supra* note 86.

⁹⁰ VIRGINIA DEPARTMENT OF TAXATION, GOVERNOR WARNER'S EXECUTIVE AMENDMENTS TO THE BUDGET FOR FY02, AND THE 2002-2004 BIENNIUM 5, at <http://www.state.va.us/Budget/02-04/govlettertoga.pdf> (last visited May 7, 2003) [hereinafter 2002-2004 BIENNIUM].

⁹¹ 2002 Iowa Acts 15E.43-1.c.

⁹² See *infra* Table 7.

assumes that the proposed Tennessee Seed Capital Qualified Investment Tax Credit program will provide \$3,000,000 in available tax credits for the program's initial calendar year, 2004, and \$4,000,000 in available tax credits per calendar year thereafter. These figures are below both North Carolina's and Virginia's statutorily available credits⁹³ yet reasonable given the proposed program's infancy and Virginia's recent reduction of available credits. These figures will also enable the current governor and his or her administration to make a strong statement regarding its dedication to technology-oriented economic development.⁹⁴

As noted above, annual available tax credits in the amount of \$3,000,000 will stimulate \$12,000,000 in corresponding qualified investments, and annual available tax credits in the amount of \$4,000,000 will stimulate \$16,000,000 in corresponding qualified investments. These corresponding investment figures will be higher in years that taxpayers request credits in excess of the annual available credits. Table 7 summarizes the amount of tax credits requested by taxpayers participating in the programs surveyed in Appendix II. Table 8 illustrates the corresponding amounts of qualified investments at a given amount of available tax credits, assuming the percentage of a qualified investment that is eligible for the credit is 25%.

⁹³ See *infra* Appendix II, Parts B. and D.

⁹⁴ Interview with Tom Rogers, *supra* note 9.

| Year | Iowa | Maine | North Carolina | Ohio | Virginia | Average |
|---------------|-------------|---------------------|---------------------------|---------------------|----------------------|----------------|
| 1992 | n/a | 35,000 | n/a | n/a | n/a | 35,000 |
| 1993 | n/a | 188,000 | n/a | n/a | n/a | 188,000 |
| 1994 | n/a | 319,000 | n/a | n/a | n/a | 319,000 |
| 1995 | n/a | 372,000 | n/a | n/a | n/a | 372,000 |
| 1996 | n/a | 352,000 | n/a | 312,500 | n/a | 332,250 |
| 1997 | n/a | 169,000 | 5,344,641 | 909,670 | n/a | 2,141,104 |
| 1998 | n/a | 390,000 | 6,450,000 | 88,568 | n/a | 2,309,523 |
| 1999 | n/a | 823,000 | 7,016,027 | 885,271 | 8,241,675 | 4,241,493 |
| 2000 | n/a | 1,321,000 | 18,997,004 | 1,204,839 | 6,531,761 | 7,013,651 |
| 2001 | n/a | 2,071,000 | 7,825,672 | 1,143,328 | 10,052,025 | 5,273,006 |
| Totals | n/a | \$ 6,040,000 | \$ 45,633,344 | \$ 4,544,176 | \$ 24,825,461 | |

| | | | | | |
|---|-----------------|------------------|------------------|------------------|------------------|
| Tax credits available per year | \$ 2,000,000.00 | \$ 3,000,000.00 | \$ 4,000,000.00 | \$ 5,000,000.00 | \$ 6,000,000.00 |
| % of investment eligible for tax credit | 25.0% | 25.0% | 25.0% | 25.0% | 25.0% |
| Correlating qualified investments | \$ 8,000,000.00 | \$ 12,000,000.00 | \$ 16,000,000.00 | \$ 20,000,000.00 | \$ 24,000,000.00 |

F. Claiming the Tax Credit

1. Offset Against Tennessee's Hall Income Tax

A taxpayer may claim the proposed credit as a direct offset against the taxpayer's Tennessee net income tax liability, which is the taxpayer's state income tax liability reduced by all other credits and exemptions. However, Tennessee does not provide individual taxpayers any other state income tax credits and provides only limited exceptions to taxable income, including the following:

- The \$1,250 single exemption or the \$2,500 joint exemption;⁹⁵
- exemption for persons 65 years of age or older having a total annual income derived from any source of \$16,200 or less, or \$27,000 or less for joint filers elderly;⁹⁶

⁹⁵ TENN. CODE ANN. § 67-2-104(a) (2000).

⁹⁶ *Id.* § 67-2-104(b).

- complete exemption for all income of blind individuals;⁹⁷ and
- all income derived from circumstances resulting in an individual becoming a quadriplegic.⁹⁸

2. Restricting the Amount of Credit a Taxpayer May Claim

Although the maximum impact on the state's revenue collections will be the amount of available tax credits in any given year, the program can defer a portion of this impact by restricting the amount of credit that a taxpayer may claim each year. Maine requires taxpayers to claim the allowable credit amount in equal installments over four years and further limits the amount a taxpayer may claim in any single year to 50% of the taxpayer's tax liability.⁹⁹ North Carolina taxpayers may not claim credits in excess of \$50,000 in any single year.¹⁰⁰ Virginia limits the amount of credit that a taxpayer may claim in a taxable year to the lesser of the taxpayer's state income tax liability or 10% of the credits available for the respective year.¹⁰¹ Iowa and Ohio taxpayers may not claim a credit amount in excess of the taxpayer's respective state tax liability.¹⁰²

The proposed program restricts the credit amount that a taxpayer may claim to the lesser of the tax credit certificate amount or 50% of the taxpayer's net income tax liability. Given a maximum qualified investment in the amount of \$200,000 and the allowable percentage of the investment eligible for the credit at 25%, a taxpayer's maximum allowable credit per year is \$50,000. Therefore, a taxpayer must have at least \$100,000 in net income tax liability to claim the maximum allowable credit.

⁹⁷ *Id.* § 67-2-104(c).

⁹⁸ *Id.*

⁹⁹ ME. REV. STAT. ANN. tit. 36, §§ 5216-B.2. - B.3 (West 2002).

¹⁰⁰ N.C. GEN. STAT. § 105-163.011(b) (2002).

¹⁰¹ Virginia's amount of available credits for 2002 is \$4,000,000. *See supra* note 90. Therefore, taxpayers may claim a credit amount that is the lesser of the taxpayer's income tax liability or \$400,000. *See* VA. CODE ANN. § 58.1-339.4(D) (Michie 2003).

¹⁰² *See* 2002 Iowa Acts 15E.43-1.a.-b.; OHIO REV. CODE ANN. §§ 122.15.2 (B)(1)-(B)(2) (Anderson 2003);

Because Tennessee's income tax rate is 6%, a married couple that files jointly must have \$1,708,667 in taxable income to have a net income tax liability of \$100,000.¹⁰³

Table 9 illustrates that in 1999 and 2000, the latest available data from the Department of Revenue, 142,977 and 148,744 taxpayers filed Tennessee income tax returns, respectively. Approximately, 8,900 taxpayers filed returns with taxable income in excess of \$50,000 in 1999, and 10,209 so filed in 2000. Forty-six taxpayers filed returns with taxable income in excess of \$2,000,000 in 1999, and 44 so filed in 2000.

| Table 9: Tennessee Income Tax Returns Filed | | | | |
|--|----------------------|-------------------------|--|---|
| Fiscal Year | Income Tax Collected | Number of Returns Filed | # of Returns with taxable income in excess of \$50,000 | # of Returns with taxable income in excess of \$2,000,000 |
| 1999 | \$180,277,750 | 142,977 | 8,917 | 46 |
| 2000 | \$198,071,186 | 148,744 | 10,209 | 44 |
| Source: Tennessee Department of Revenue | | | | |

3. Allocation of Available Credits When Requests Exceed Available Credits

The states surveyed in Appendix II that allocate available credits among taxpayers in years when the requested credits exceed the available credits prevent taxpayers from realizing the full anticipated benefit for participating in the program.¹⁰⁴ The respective programs allow a taxpayer to claim only a percentage of the taxpayer's requested credit amount in these years. Specifically, Table 10 below shows that North Carolina's program allowed its program participants to claim only 31.58% of their requested tax credit amount in 2000, and increased to 76.67% in 2001. Similarly, Virginia's program allowed its program participants to claim only 76.54% of their requested tax credit amount in 2000, but decreased to 49.74% in 2001. The participants in these respective programs lose forever the portions of requested credits disallowed by the allocation procedure. Further, the administrators do not notify taxpayers of the allocation until after the respective state's income tax

¹⁰³ This figure is determined by adding \$100,000 and the \$2,500 exemption and dividing the sum by the tax rate, 6%.

¹⁰⁴ See *infra* Appendix II, Parts B. and D. (discussing North Carolina's and Virginia's tax credit programs).

return filing deadline. Therefore, taxpayers are unable to determine their amount of their allowable credit until after they file their tax returns.¹⁰⁵

| | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|------|--------|--------|--------|--------|
| North Carolina ^(a) | 100% | 93.02% | 85.52% | 31.58% | 76.67% |
| Virginia ^(b) | n/a | n/a | 60.67% | 76.54% | 49.74% |
| ^(a) North Carolina Department of Revenue ^(b) Virginia Department of Taxation | | | | | |

Alternatively, taxpayers eligible to claim the credit in years when there are insufficient credits available may claim the credits in subsequent years when sufficient credits become available.¹⁰⁶ However, this method creates a risk that the annual available tax credits may lag behind the annual amount of tax credits requested by taxpayers, and taxpayers essentially must wait their turn to claim their credit. Adopting this method without including some form of allocation method effectively delays a taxpayer's ability to claim at least a portion of the credit by a year or more.

The proposed program's intent is to enable taxpayers to receive the entire benefit of their allowable credit as soon as possible. In years in which taxpayers request credits in excess of the year's available credits, this intent requires an allocation method to ensure that each taxpayer may claim at least a portion of the credit in the year same year the qualified investment is made. Under the proposed program's current parameters and assumptions, a minimum of 81 taxpayers must request the credits before the administrator must allocate a year's available credits.¹⁰⁷ Table 11 compares the first-year participation level of the programs surveyed in Appendix II.

¹⁰⁵ See *id.*

¹⁰⁶ See *id.* at Part A. (discussing Maine's tax credit program).

¹⁰⁷ Assuming available tax credits of \$4,000,000 and dividing that amount by the percentage of qualified investment eligible for the credit (25%), yields \$16,000,000 in corresponding qualified investments. This amount divided by the maximum qualified investment amount (\$200,000), yields 80 qualified investments. Thus, if 81 taxpayers use these numbers, the administrator will be forced to allocate.

| Table 11: Number of Taxpayers Requesting Tax Credit in the Program's First Year | | | | |
|--|------------------|--------------------|--------------------|-------------------|
| Iowa | Maine | North Carolina | Ohio | Virginia |
| n/a ^(a) | 5 ^(b) | 635 ^(c) | n/a ^(d) | 89 ^(e) |
| ^(a) Iowa's program becomes available January 1, 2003. ^(b) Finance Authority of Maine ^(c) North Carolina Department of Revenue ^(d) Ohio does not track this information, Ohio Department of Taxation ^(e) Virginia Department of Taxation | | | | |

Because the proposed program's participation level is unknown, the program may initially require the administrator to allocate the available tax credits in years in which the requested credits exceed the available credits. The respective taxpayers will then receive their remaining credit via a priority in the subsequent year's distribution of available credits. If participation in the program renders this provision impractical, the General Assembly may amend it accordingly.

F. Ability to Monitor and Evaluate the Program

The General Assembly must have access to timely information to evaluate the program's participation level and success. Therefore, the program establishes reporting requirements for the administrator, qualified businesses, and the Department of Revenue. The program also establishes registration requirements for pre-qualified businesses and taxpayers. The administrator must report the program's annual and cumulative activity, and each qualified business must file annual reports summarizing the business's progress since the qualified investment date. The Department of Revenue must report the amount of credits claimed and the number of taxpayers claiming the credits. Pre-qualified businesses and taxpayers must register with the administrator before executing a qualified investment.

The administrative registration and approval processes of qualified businesses and taxpayers before a qualified investment's execution date serve several functions. First, the administrator can review applications on an as-needed basis throughout the year. Second, the procedures allow the interested parties to measure the program's participation level throughout the year. Third, the publicly available qualified business approvals provide taxpayers with a centralized source of information for potential investment targets. Finally, the administrator is in a position to determine whether taxpayers will request credits in excess of the annual available credits immediately after the calendar year end rather than delaying any necessary allocation procedure until after taxpayers have already filed their state income tax returns.

G. Qualified Investments

1. Investments Directly in Qualified Businesses

Under the proposed program, a qualified investment is an investment in a qualified business in which a taxpayer may claim a corresponding tax credit. Because the structure of the proposed program strives for simplicity, the initial characterization of a qualified investment is a cash investment for the purchase of a qualified business's equity securities. A broader definition risks encompassing too many investments that qualify for the credit. As a result, taxpayers may request credits in considerable excess of the credits available each year,¹⁰⁸ and all participating taxpayers consequently would receive a reduced allowable credit amount.

The proposed program contemplates an investment that provides a benefit for the qualified business—that is, capital for the business to improve or to expand the business' operations. Virginia's program disallows a qualified investment if the qualified business uses 50% or more of the investment proceeds within one year of the investment date to retire or reduce debt or equity incurred by the qualified business before the investment date.¹⁰⁹ Maine requires qualified businesses to expend the qualified proceeds on plant, equipment, research and development, or working capital.¹¹⁰ The proposed program follows the examples of these states by specifically stating the permitted uses of investment proceeds, and it requires a business to state its intended use of proceeds when registering with the administrator as a qualified business. The proposed program's intent is to prohibit a qualified business from using the proceeds to satisfy existing debt at the time of application or for distributions to its owners. Although debt reduction is beneficial, the holder of the debt is the ultimate beneficiary because the holder is no longer dependent upon the success of the business's operations for repayment.

The proposed program restricts a taxpayer's aggregate qualified investment amount in one or more qualified businesses to \$200,000 per year. Further, a taxpayer's cumulative qualified investment amount in any one qualified business may not exceed \$200,000. The ultimate intent of these limitations is to (1) maximize the annual number of taxpayers eligible to claim the credits, (2) maximize the number of

¹⁰⁸ See *infra* Appendix II, Parts B. and D. (discussing North Carolina's and Virginia's tax credit programs).

¹⁰⁹ See *infra* Appendix II, Part D.

¹¹⁰ See *id.* at Part A.

qualified businesses that receive qualified investments, and (3) compel a qualified business to seek qualified investments from at least three different taxpayers before reaching its maximum amount of allowable qualified investments.¹¹¹

2. Investments in Venture Capital Funds

The proposed program's initial definition of a qualified investment does not include investments into pass-through venture fund entities that in turn invest in qualified businesses. Several states provide a tax credit for qualified investments in this type of venture fund, such as investment partnerships or "angel funds."¹¹² These pass-through entities allow investors to pool their money and invest together in seed- and early-stage companies, thereby reducing risk exposure.

Several individuals currently are spearheading efforts to establish statewide and regional angel venture funds in Tennessee, and they have expressed interest in including investments in a venture capital fund as a qualified investment.¹¹³ Inclusion of these investments within the definition of a qualified investment will substantially increase the amount of investments in these funds. Although this concept seems simple at first glance, providing taxpayers a credit for an investment in an eligible fund raises issues that will substantially increase the program's complexity.

First, a qualified investment in a venture fund increases the program's administrative layers. The venture fund will apply for a tax credit certificate and then distribute the credits to its respective owners. Therefore, the fund should have an objective to invest in the program's intended recipients. Consequently, the administrator must evaluate whether the venture fund is an eligible recipient of qualified investments, evaluate whether each of the venture fund's investments is a qualified investment into a qualified business, and determine whether each of the venture fund's respective owner's is a taxpayer eligible to claim the credit.

Second, the issue arises as to when a taxpayer may claim a credit for an investment into an eligible venture fund. If a taxpayer receives a credit in the year of an investment into a venture fund and the fund does not subsequently invest the proceeds in qualified businesses within a reasonable time period, the taxpayer essentially receives a tax credit for an investment that did not reach the program's

¹¹¹ *Id.*

¹¹² *See id.* at Parts A., B., and E.

¹¹³ Interview with Tom Rogers, *supra* note 9.

intended beneficiaries. However, any milestone dates for the venture fund's investment of monies into qualified businesses may impair the fund manager's ability to make objective investment decisions.

Therefore, in the interest of simplicity and minimal administrative overhead, the proposed program does not include an investment into a pass-through venture fund within the definition of a qualified investment. The program's drafters and the General Assembly may subsequently amend the program to include these investments once they evaluate the program's effectiveness and shortcomings.

H. Qualified Businesses

The proposed program focuses on the equity financing needs of Tennessee's seed-stage businesses that have the greatest potential to bring new capital and new jobs to Tennessee. Seed financing often comes in amounts less than \$500,000 but is usually below \$1,000,000.¹¹⁴ Seed-stage companies in high-growth sectors generally have their funds tied up in expensive investments, such as facilities, staffing, equipment, research and development, and intellectual property protection.¹¹⁵ As alluded to earlier, these companies have few sales and may be losing money because their products are still in development.¹¹⁶

The proposed program therefore attempts to ensure that qualified investments target only seed-stage businesses. The program requires a qualified business to be fewer than three years old and to have annual gross sales of \$3,000,000 or less. Further, a qualified business may not receive more than \$600,000 in qualified investments. This \$600,000 limitation ensures that the investments eligible for the program's credits truly represent seed capital for a qualified business. This limitation also promotes maximum distribution of qualifying investments among the state's qualified businesses. Moreover, the \$600,000 limitation coupled with taxpayers' maximum cumulative qualified investment amount of \$200,000 into any one qualified business theoretically ensures that at least three investors will scrutinize the qualified business's business model. Consequently, only the most promising seed-stage companies will receive the program's maximum amount of qualified investments.

¹¹⁴ See *supra* note 41.

¹¹⁵ *Id.*

¹¹⁶ *Id.*

Another reason for the proposed program's focus on seed-stage businesses is that Tennessee already has several funds that focus on established early stage companies that have progressed beyond the seed stage. In particular, the TennesSeed Fund seeks to make investments in the range of \$250,000 to \$2,000,000 in established, early-stage technology companies and focuses on companies located in Tennessee and the surrounding southeastern states.¹¹⁷ The TennesSeed Fund specifically states that it only invests in stages where angel investors predominate as long as it is possible for the fund to obtain typical venture capital terms and conditions for its investment.¹¹⁸ The fund does not invest in deals that require it to be in a junior position to an angel investor.¹¹⁹ The Southern Appalachian Fund also focuses on established early-stage companies located in low income and rural areas of Tennessee, Kentucky, and northern regions of Alabama, Georgia, and Mississippi.¹²⁰ Furthermore, Tennessee's technology proponents intend to introduce legislation for programs designed to increase the availability of venture capital to young businesses in all sectors of the state's economy that have progressed beyond the seed-stage.¹²¹ These prospective programs include broadening the restrictions relating to the investment of the state's pension funds.¹²²

The proposed program's focus is primarily on technology-oriented, high-growth companies that require the backing of venture capital. These companies "employ highly skilled workers" such as engineers, scientists, and managers at about four times the annual rate compared with the overall United States workforce.¹²³ However, the program should not limit itself to only one type of market sector. The program does not want to exclude new businesses that provide the same economic development benefits as technology-oriented businesses. Many businesses that are not technology-oriented may attract significant capital to the state in the form of new jobs and increased sales. Therefore, the program provides a "backdoor" for businesses that may not fit the definition of a "technology company" but otherwise falls within the program's intended beneficiaries.

¹¹⁷ Interview with Don Welty, *supra* note 34.

¹¹⁸ *Id.*

¹¹⁹ *Id.*

¹²⁰ *Id.*

¹²¹ Interview with Tom Rogers, *supra* note 9.

¹²² *Id.*

¹²³ ONORATO, *supra* note 11, at 10.

I. Taxpayers Eligible to Claim the Tax Credit

The program's intent is to include the maximum number of taxpayers that may claim the credit. However, the program does not intend to reward a taxpayer with a tax credit for an investment where the taxpayer has the ability to personally benefit from qualified investment proceeds. Therefore, the program excludes taxpayers that are in a position to exercise discretionary control over qualified investment proceeds.

J. Required Holding Period of Eligible Investments

The proposed program requires a taxpayer to hold the investment for at least two years before receiving a return of investment. This requirement prevents a taxpayer from making an investment and subsequently redeeming the investment immediately upon receiving the corresponding tax credit certificate. The program enforces this concept by requiring taxpayers to make each qualified investment under a written agreement that includes a provision that prevents the taxpayer from redeeming any portion of the investment within two years of the investment date. Further, a taxpayer is subject to forfeiture of any remaining allowable credits and recapture of any previously claimed credits for failure to meet the required holding period.

This two-year holding period provides a taxpayer an opportunity either to redeem the qualified investment and possibly recycle the proceeds into other qualified businesses or to allow the investment to remain in the business. A longer holding period requirement may actually discourage a qualified investment. For example, a taxpayer may not want to commit funds in a very risky investment for a period of five years.

K. Allowable Return on Investment

Return on investment restrictions delay an investor from participating in the benefits of a successful investment. The proposed program focuses on seed-stage businesses that likely will re-invest any available retained earnings into expansion rather than distribute them to investors. However, if the business is exceptionally successful, the program does not limit the qualified business from rewarding its investors with a return on investment, as long as it does not provide the taxpayer a return of investment within the prescribed holding period.

L. Compliance with Program Requirements

The program includes forfeiture and recapture provisions to ensure that taxpayers businesses comply with the program requirements.

APPENDIX II. SURVEY OF QUALIFIED INVESTMENT TAX CREDIT PROGRAMS IN OTHER STATES

A number of states currently offer some form of qualified investment tax incentive program. These states have taken a number of approaches in structuring their programs with varying complexity and success. The following subsections describe the programs of five states in chronological order of enactment:

- (1) Maine – the longest running program, reasonable success;
- (2) North Carolina – successful program, qualified investments include equity and subordinated debt, businesses receiving investments must report new jobs created and the wages paid to these new jobs;
- (3) Ohio – focuses on small technology-oriented businesses, no limitation on the amount of credits available per year;
- (4) Virginia – successful program but hindered by budget constraints, does not specifically focus on technology-oriented businesses; and
- (5) Iowa – most recent state to enact its program, allows tax credits for investments into qualified businesses and qualified venture funds.

Table 12 alphabetically provides a summary of these five programs' key components. Each of the following subsections provides an overview of the respective state program, a description of the program's performance to date, who administers the program, the amount of credits available under the program, the percentage of an investment eligible for the credit, the definition of a qualified business and the related certification procedures employed, the definition of a qualified investment, a description of the taxpayers who are eligible to claim the credit, how a taxpayer may claim the credit, the required holding period and allowable return on a qualified investment, circumstances that may lead to the forfeiture of the credit, and the program's administrative reporting requirements.

| Table 12: Summary of State Qualified Investment Tax Credit Programs | | | | | |
|---|---|---|--|--|--|
| QB = Qualified Business | Iowa | Maine | North Carolina | Ohio | Virginia |
| % of qualified invest. Eligible for credit | 20% | 40% up to 60% | 25% | 25% | 25% |
| Amortization of credit | Must claim tax credit in 3 rd year | 4 years | N/A | N/A | N/A |
| Taxpayer's maximum annual qualified investments | \$250,000 per qualified business | \$500,000 | \$250,000 per qualified business | \$150,000 per credit certificate | Depends upon the year's available credits |
| Taxpayer's maximum cumulative investment in a QB | No limit | \$500,000 per qualified business over 3 years | \$250,000 | No limit | No limit |
| Taxpayer's max. # of qualified investments | 5 per year | No limit | No limit | No limit | No limit |
| Taxpayer's maximum credit amount claimed per year | May not exceed taxpayer's tax liability | 50% of tax liability | Lesser of tax liability or \$50,000 per investment | \$37,500 per credit certificate | Lesser of tax liability or 10% of available credits |
| Carryover of unused credits | 5 years | 15 years | 5 years | 15 Years | 15 years |
| Available tax credits per year | \$3,000,000 for 2002 & 2003, \$4,000,000 for 2004 | Approx. \$3,000,000 (Rolling cumulative limit until \$30,000,000 in 2008) | \$6,000,000 | No limit, approx. \$5,000,000 credits remain available | \$20,000,000 per year, but 2002 budget limits to \$4,000,000 |
| Total tax credits available under the program | \$10,000,000 | \$30,000,000 | No cap | \$10,000,000 | No cap |
| Maximum investments a QB may receive | No limit but QB net worth must be under \$3,000,000 | \$5,000,000 | No limit | \$1,000,000 | No limit |

A. Maine's Seed Capital Tax Credit Program

1. Overview

Maine enacted its Seed Capital Tax Credit program in 1988.¹²⁴ The legislature enacted the program after recognizing that the growth of new and existing small businesses within its borders would produce increased job opportunities for its residents, produce more spending within the state, and increase the municipal tax base.¹²⁵ The legislature concluded that small new and existing businesses could provide significant economic benefits to the state if these businesses could obtain sufficient seed-equity financing to carry them from start-up through the initial development phases of their business.¹²⁶ The program's goal is to encourage high net worth individuals and other legal entities to invest directly in Maine's start-up business ventures and in private venture funds that invest in these businesses.¹²⁷ Given Maine's geographic location, the program focuses on start-up manufacturers, service providers with a majority of sales derived from outside the state, companies engaged in the development of advanced technologies, and any other business that can bring significant capital into the state of Maine.¹²⁸ The program also places a priority on natural resource entities by reserving \$500,000 of the program's available tax credits for qualified investments in these entities.¹²⁹

¹²⁴ 1987 Me. Acts 854.

¹²⁵ ME. REV. STAT. ANN. tit. 10, § 1100-T.1 (West 2002).

¹²⁶ *Id.*

¹²⁷ *See* ME. REV. STAT. ANN. tit. 10, § 1100-T.2-A; CODE ME. R. § 94-457-307 (2003).

¹²⁸ *See* ME. REV. STAT. ANN. tit. 10, § 1100-T.2.B.

¹²⁹ *See* 2002 Me. Legis. Serv. 642 (West); *see also* CODE ME. R. § 94-457-307 5.

2. Program Performance

Table 13: Maine Seed Capital Tax Credit Program

| Year | Tax Credits Claimed ^(a) | # of Taxpayers Claiming Credit ^(a) | Corresp. Investment Amount ^(a) | Companies Receiving Investment ^(a) | Avg. Size of Taxpayers' Investment ^(b) | Avg. Size of Tax Credit Claimed ^(c) | Avg. Size Investment Received by Business ^(d) |
|--------|------------------------------------|---|---|---|---|--|--|
| 1992 | \$35,000 | 5 | \$115,000 | 3 | \$23,000 | \$7,000 | \$38,333 |
| 1993 | 188,000 | 21 | 626,000 | 5 | 29,810 | 8,952 | 125,200 |
| 1994 | 319,000 | 45 | 1,064,000 | 6 | 23,644 | 7,089 | 177,333 |
| 1995 | 372,000 | 52 | 1,239,000 | 7 | 23,827 | 7,154 | 177,000 |
| 1996 | 352,000 | 23 | 1,174,000 | 9 | 51,043 | 15,304 | 130,444 |
| 1997 | 169,000 | 31 | 563,000 | 9 | 18,161 | 5,452 | 62,556 |
| 1998 | 390,000 | 60 | 1,299,000 | 13 | 21,650 | 6,500 | 99,923 |
| 1999 | 823,000 | 87 | 2,743,000 | 14 | 31,529 | 9,460 | 195,929 |
| 2000 | 1,321,000 | 147 | 4,902,000 | 21 | 33,347 | 8,986 | 233,429 |
| 2001 | 2,071,000 | 115 | 5,952,000 | 29 | 51,757 | 18,009 | 205,241 |
| Totals | \$6,040,000 | 586 | \$19,677,000 | 116 | \$33,578 | \$10,307 | \$169,629 |

^(a) Finance Authority of Maine

^(b) Calculated by dividing Corresp. Investment Amount by # of Taxpayers Claiming Credit.

^(c) Calculated by dividing Total Credits Claimed by # of Taxpayers Claiming Credit.

^(d) Calculated by dividing Corresp. Investment Amount by Companies Receiving Investment.

Table 13 above summarizes the performance of Maine's program. Since 1992, the program's administrator has issued 586 tax credit certificates with a cumulative value of \$6.04 million.¹³⁰ These credits correspond to approximately \$19.677 million in qualified investments, and taxpayers made these qualified investments in 586 individual businesses.¹³¹ The administrator estimates that the qualified businesses receiving qualified investments currently generate approximately \$750,000 per year in tax revenues for the state of Maine.¹³² The administrator believes that the cumulative tax credits issued between 1989 and 2001 already are, or

¹³⁰ See *supra* Table 13.

¹³¹ *Id.*

¹³² Interview with Finance Authority of Maine (Oct. 2002). The tax revenue figure does not consider any multiplier effects and excludes one-time tax payments from capital expenditures or corporate income tax. *Id.*

soon will be, completely offset by the personal income taxes generated from the active qualified businesses.¹³³

2. Program Administrator

The Finance Authority of Maine (“FAME”) administers the program.¹³⁴ FAME is an independent state agency that develops and administers programs related to the financing of both higher education and business in the state of Maine.¹³⁵

3. Aggregate Tax Credits Available Under the Angel Program

The program provides an aggregate total of \$30,000,000 in tax credits.¹³⁶ The administrator has issued \$6.04 million in tax certificates since the program’s inception through taxable year 2001.¹³⁷ Although the program does not have a specific sunset date, the program restricts the cumulative total tax credits that the administrator may issue through 2007 as follows:

- up to and including calendar year 2002, \$11,000,000;
- up to and including calendar year 2003, \$14,000,000;
- up to and including calendar year 2004, \$17,000,000;
- up to and including calendar year 2005, \$20,000,000;
- up to and including calendar year 2006, \$23,000,000;
- up to and including calendar year 2007, \$26,000,000; and
- \$30,000,000 thereafter.¹³⁸

¹³³ *Id.*

¹³⁴ ME. REV. STAT. ANN. tit. 36, § 5216-B.1.A. (West 2002); *see also id.* tit. 10, § 1100-T.1.

¹³⁵ Finance Authority of Maine, Introductory Page, *available at* <http://www.famemaine.com>.

¹³⁶ ME. REV. STAT. ANN. tit. 10, § 1100-T.4.

¹³⁷ *See supra* Table 13.

¹³⁸ 2002 Me. Legis. Serv. 642 (West) (amending ME. REV. STAT. ANN. tit. 10, § 1100-T.4); *see also* CODE ME. R. § 94-457-307 4.D (2003).

4. Percentage of a Qualified Investment Eligible for the Tax Credit

The program provides a tax credit in the amount of 40% of a qualified investment.¹³⁹ In 2002, the legislature amended the program to provide an additional 20% tax credit for qualified investments in qualified businesses located within high unemployment areas, as determined by FAME.¹⁴⁰ This additional incentive increases the allowable tax credit to 60% of a qualified investment in a high unemployment area.¹⁴¹ While FAME is yet to finalize the definition of “high unemployment areas,” FAME expects to propose that it be defined as those areas where the unemployment rate exceeds the state’s average rate, as reported by the Maine Department of Labor.¹⁴²

5. Qualified Businesses

A taxpayer may directly make a qualified investment in a qualified business or a qualified venture fund. A qualified venture fund is a distinct, private, and legal entity organized to distribute funds “from two or more unrelated parties used for” equity investments in businesses unrelated to the entity “in which an investor proposes to make an investment.”¹⁴³ A total of 586 qualified businesses have received qualified investments since 1992.¹⁴⁴ A qualified business is a business that:

- (1) is located in Maine;¹⁴⁵
- (2) has annual gross sales of \$3 million or less as of the date the business applies to the administrator as a qualified business, determined by the administrator based on the business’s most recent annual financial

¹³⁹ ME. REV. STAT. ANN. tit. 10, §§ 1100-T.2.A to -2-A.A.

¹⁴⁰ 2002 Me. Legis. Serv. 642 (West) (amending ME. REV. STAT. ANN. tit. 10, § 1100-T).

¹⁴¹ *Id.* (amending ME. REV. STAT. ANN. tit. 10, § 1100-T.2.A to -2-A.A).

¹⁴² FINANCE AUTHORITY OF MAINE, MAINE SEED CAPITAL TAX CREDIT PROGRAM FACT SHEET (May 2002), *available at* <http://www.famemaine.com>.

¹⁴³ CODE ME. R. § 94-457-307 1.F.

¹⁴⁴ *See supra* Table 13.

¹⁴⁵ ME. REV. STAT. ANN. tit. 10, § 1100-T.2.B (West 2002).

statements as well as its most recently available internally prepared statements;¹⁴⁶

- (3) requires the full-time, professional activity of at least one of the principal owners;¹⁴⁷
- (4) is a manufacturer, a service provider with 60% of sales derived from outside Maine or to out-of-state residents, a business engaged in the development of advanced technologies, or one that brings significant capital into Maine;¹⁴⁸
- (5) is a corporation, partnership, limited liability company, joint venture, or other legal business entity, and, if applicable, must be in good standing and authorized to do business in the state of Maine,¹⁴⁹ and
- (6) has not received more than an aggregate of \$5 million in qualified investments.¹⁵⁰ (This limitation does not restrict a qualified business from receiving additional investments ineligible under the program.¹⁵¹)

6. Application and Certification of a Qualified Business

A business must submit an application and a \$250 fee to the administrator before execution of the investment.¹⁵² The application includes information identifying and describing the business or fund, the amount, source and purpose of

¹⁴⁶ *Id.* § 1100-T.2.E.

¹⁴⁷ *Id.*

¹⁴⁸ *Id.* § 1100-T.2.B. In determining whether a business brings new capital into the state, the administrator considers whether the investment (i) will create jobs within the state, (ii) produce sales and/or income tax revenue for the state; and (iii) results in new capital being brought into the state in an amount at least equal to the amount of the credit sought within two years of the granting of the credit. CODE ME. R. § 94-457-307 3.A.1.(d) (2003).

¹⁴⁹ CODE ME. R. § 94-457-307 3.A.4 (2003).

¹⁵⁰ 2002 Me. Legis. Serv. 642 (West) (amending ME. REV. STAT. ANN. tit. 10, § 1100-T.2.C.); *see also* MAINE SEED CAPITAL TAX CREDIT PROGRAM FACT SHEET, *supra* note 142.

¹⁵¹ *Id.*

¹⁵² CODE ME. R. §§ 94-457-307 2.E.-F.

the investment, and terms and conditions of the investment.¹⁵³ The administrator will not issue a tax credit certificate to a taxpayer for an investment made before the date that the administrator receives the qualified business application. The administrator does not issue a separate qualified business certificate to the qualified business.¹⁵⁴

7. Administrative Disclaimer

The administrator does not endorse a business or the prudence of an investment by issuing a tax credit certificate.¹⁵⁵ Further, the administrator will not review the financial or business prospects of any business or review any materials used by the business to solicit the investment.¹⁵⁶ Finally, the administrator is not responsible to taxpayers for any losses resulting from a taxpayer's qualified investment.¹⁵⁷

8. Qualified Investments

A taxpayer may directly make a qualified investment in a qualified business or into a private venture capital fund.¹⁵⁸ A taxpayer's direct investment into a qualified business must meet the following criteria:

- (1) "The investment must be at risk in the business and may not be secured by a lien on business assets or a personal guaranty of any principal owner";¹⁵⁹
- (2) "The investment must be made under an agreement where ... the investment may not be repaid to the investor during the five year period beginning on the date the cash is received by the [qualified] business [or

¹⁵³ *Id.* § 307 2.D.

¹⁵⁴ *Id.* § 307 4.B.

¹⁵⁵ *Id.* § 307 4.E.

¹⁵⁶ *Id.*

¹⁵⁷ *Id.*

¹⁵⁸ *See* ME. REV. STAT. ANN. tit. 10, §1100-T.2. and T.2-A.

¹⁵⁹ *Id.* § 1100-T.2.G.; *see also* CODE ME. R. § 94-457-307 3.B.1 (2003).

fund], unless circumstances, such as the sale of the business, result in significant change in ownership or operations of the business;¹⁶⁰

- (3) “The investment may not result in the [taxpayer or fund], in conjunction with any other [taxpayers] participating in the [p]rogram, owning 50% or more of the [qualified] business”;¹⁶¹
- (4) The qualified business must expend the qualified investment proceeds on “plant, equipment, research and development, or working capital for the business or such other business activity” as approved by the administrator;¹⁶² and
- (5) The taxpayer’s cumulative investments in the qualified business during any consecutive three-year period do not exceed \$500,000.¹⁶³ (The program does not limit the number of qualified businesses in which a taxpayer may make a qualified investment.¹⁶⁴)

A taxpayer’s investment into a private venture fund must meet roughly parallel requirements. First, the “amount invested by the fund in [a qualified] business must be equal to or greater than the amount of the investment in the fund that is receiving the tax credit.¹⁶⁵ Second, the qualified business must spend the fund’s investment proceeds on acquisition, improvement or maintenance of real property or fixed assets, research and development or working capital.”¹⁶⁶ Third, “[b]oth the [taxpayer’s] investment in the fund and the fund’s investment in any [qualified] business must be at risk, and neither investment may be secured by a lien on business or fund assets or a personal guaranty of any principal owner of [a qualified] business.”¹⁶⁷ Fourth, the “[taxpayer’s] investment in a fund must be made

¹⁶⁰ CODE ME. R. § 94-457-307 3.B.2.

¹⁶¹ ME. REV. STAT. ANN. tit. 10, § 1100-T.2.H.; CODE ME. R. § 94-457-307 3.B.3.

¹⁶² ME. REV. STAT. ANN. tit. 10, § 1100-T.2.F.

¹⁶³ 2002 Me. Legis. Serv. 642 (West) (amending ME. REV. STAT. ANN. tit. 10, § 1100-T.2.D.)

¹⁶⁴ MAINE SEED CAPITAL TAX CREDIT PROGRAM FACT SHEET, *supra* note 142.

¹⁶⁵ CODE ME. R. § 94-457-307 3-A.A.

¹⁶⁶ *Id.* § 94-457-307 3-A.B.

¹⁶⁷ *Id.* § 94-457-307 3-A.C.

under an agreement whereby the investment is subject to loss in its entirety, and may not have unilateral ‘put’ rights during the five-year period [after the closing date].”¹⁶⁸ Finally, taxpayers applying for a credit may not collectively own 50% or more in any qualified business that receives qualified investments from the fund.¹⁶⁹

Apart from promoting investment in general, the program places a priority on investments in qualified businesses that are “natural resource enterprises.” A natural resource enterprise is “an agricultural enterprise or a fishing enterprise, but does not include selling of food at wholesale or retail, except when that selling is carried out as part of the natural resource enterprise.”¹⁷⁰ The administrator reserves \$500,000 of the aggregate authorized tax credits for investments in these entities.¹⁷¹ However, the administrator may use this \$500,000 reservation for investments in any qualified business “if the aggregate amount of certificates issued for investments in businesses [that] are not natural resource enterprises reaches the aggregate authorized [limit] less \$500,000.”¹⁷²

9. Taxpayers Eligible to Claim the Tax Credit

Individuals, partnerships, trusts, limited liability companies, corporations or other legal business entities may claim the tax credit.¹⁷³ However, a principal owner or a spouse of a principal owner in a qualified business may not claim the credit.¹⁷⁴ A “principal owner” is one who participates in the control of the business, and who, together with others, owns 50% or more of the qualified business.¹⁷⁵ A shareholder who participates in the management of the business on a full time basis is also a principal owner.¹⁷⁶ Finally, a parent, brother, sister, or child of a principal owner may

¹⁶⁸ *Id.* § 94-457-307 3-A.D.

¹⁶⁹ *Id.* § 94-457-307 3-A.E.

¹⁷⁰ ME. REV. STAT. ANN. tit. 10, §963-A.41 (West 2001).

¹⁷¹ *Id.* § 1000-T.2.H.3; *see also* CODE ME. R. § 94-457-307 5.

¹⁷² CODE ME. R. § 94-457-307 5.

¹⁷³ *Id.* § 94-457-307 1.I.

¹⁷⁴ ME. REV. STAT. ANN. tit. 10, § 1100-T.2.E.

¹⁷⁵ CODE ME. R. § 94-457-307 1.L.

¹⁷⁶ *Id.*

not receive a tax credit certificate if the person has any existing ownership interest in the qualified business.¹⁷⁷

10. Claiming the Tax Credit

A taxpayer must submit an application and a \$100 fee to the administrator prior to executing the investment.¹⁷⁸ The administrator will not issue a tax certificate to a taxpayer before receiving applications from both the qualified business and the taxpayer.¹⁷⁹ Taxpayers must claim 25% of the credit in the investment's taxable year and 25% per year in each of the next three taxable years.¹⁸⁰ However, a taxpayer may not claim a credit amount in any one year in excess of 50% of the taxpayer's tax liability.¹⁸¹ Taxpayers may carry forward unused credits for a period of up to fifteen years provided that the total credit amount in a carry-forward year meets the same 50% limitation.¹⁸² Taxpayers eligible to claim the credit in a year when there are insufficient credits available are entitled to claim the credit when sufficient credits become available.¹⁸³ The administrator determines the available credits distribution priority by the order in which it receives taxpayer applications.¹⁸⁴

11. Qualified Investment Required Holding Period

A taxpayer may not receive a return of investment within five years of the investment date "unless circumstances, such as the sale of the business, result in significant change in ownership or operations of the business."¹⁸⁵

¹⁷⁷ ME. REV. STAT. ANN. tit. 10, § 1100-T.2.E.

¹⁷⁸ CODE ME. R. § 94-457-307 2.A. and 2.F.

¹⁷⁹ *Id.* § 94-457-307 4.B.

¹⁸⁰ 2002 Me. Legis. Serv. 642 (West) (amending ME. REV. STAT. ANN. tit. 36, § 5216-B.2).

¹⁸¹ ME. REV. STAT. ANN. tit. 36, § 5216-B.3.

¹⁸² *Id.* § 5216-B.4.

¹⁸³ ME. REV. STAT. ANN. tit. 10 § 1100-T.4.

¹⁸⁴ CODE ME. R. § 94-457-307 4.D.A (2003).

¹⁸⁵ *Id.* § 94-457-307 3.B.2.

12. Allowable Return on Investment

“Taxpayers may receive a reasonable return on the investment from the business in the form of royalties, stock, [stock options or warrants], interest, dividends, ... or other form of return [that is] not intended to be a repayment of principal during the required five-year [holding] period.¹⁸⁶ However, before the payment of any return on investment, the administrator must approve whether and the extent to which the qualified business may pay any such return to the taxpayer.¹⁸⁷

13. Forfeiture and Recapture of the Credit

An administrator “may revoke a tax ... certificate if any representation ... in connection with the application for the certificate proves to have been false when made or if the applicant violates any conditions ... stated [on] the tax credit certificate.”¹⁸⁸ “The revocation may be in full or in part as the [administrator] may determine.”¹⁸⁹ Any credit amount previously claimed is then subject to recapture.

14. Administrator Reporting Requirements

“The names of participating [taxpayers] and funds, the amount of certificates issued to each [taxpayer], the names of businesses benefiting from [the] investments, the nature of the business and the intended use of proceeds [must] be public information.”¹⁹⁰

15. Qualified Business Reporting Requirements

Any qualified business whose investors receive a tax credit must annually report the following information regarding the business’s activities during the calendar year in which the qualified business received a qualified investment: (1) total amount of private investment received, (2) total number of persons employed as of

¹⁸⁶ ME. REV. STAT. ANN. tit. 10, § 1100-T.2.G.; CODE ME. R. § 94-457-307 3.B.2.

¹⁸⁷ ME. REV. STAT. ANN. tit. 10, § 1100-T.2.G.; CODE ME. R. § 94-457-307 3.B.2.

¹⁸⁸ ME. REV. STAT. ANN. tit. 10, § 1100-T.5.

¹⁸⁹ *Id.*

¹⁹⁰ CODE ME. R. § 94-457-307 7.

December 31st, (3) total number of jobs created and retained, (4) total annual payroll, and (5) total sales revenue.¹⁹¹

16. Lessons Learned

Maine's program requires taxpayers to amortize their allowable credits over four years and also limits a taxpayer's claimable credit amount in any one year to 50% of the taxpayer's tax liability. These restrictions defer the program's impact on state revenues by preventing a taxpayer from claiming the full allowable credit amount in a single year. The program also requires a taxpayer to hold a qualified investment for five years. Thus, a taxpayer's ability to obtain a return of investment depends on the business's level of success at the end of the fifth year. These claimable credit amount restrictions and holding period requirements effectively expose an already high-risk investment in a small business to additional risk by forcing taxpayers to amortize their return on investment attributable to the credits and imposing a five-year waiting period before a redemption event. However, a program could reduce this additional risk exposure by reducing the qualified investment holding period requirements to two or three years while still deferring the program's impact on state revenues.

Furthermore, in Maine, the administrator gives priority in the distribution of a year's available credits to eligible taxpayers that did not receive their allowable credits in the prior year due to insufficient credits. As reported, the administrator determines this priority distribution by the order in which it receives taxpayer applications. In the event that taxpayers request credits in excess of a year's available credits, this priority system prevents taxpayers from determining their allowable credit amount. For example, a taxpayer that makes a qualified investment when insufficient credits are available will not be able to claim any credit amount until the subsequent year. In this event, the priority system effectively increases a taxpayer's claimable credit amortization period to five or more years. An allocation method for years in which taxpayer requests for credits exceed the available credits would ensure that all taxpayers receive at least a partial tax benefit for their respective investments. A priority system could then prioritize the subsequent year's available credits to the taxpayers subject to the allocation method. In the event that this subsequent year's requested credits also exceed the amount available of credits, the administrator could again implement the allocation method.

¹⁹¹ 2002 Me. Legis. Serv. 642 (West) (amending ME. REV. STAT. ANN. tit. 10, § 1100-T).

B. North Carolina's Tax Credits for Qualified Business Investments

1. Overview

North Carolina enacted its Tax Credits for Qualified Business Investments program in 1993.¹⁹² In 1998, the legislature repealed the program for investments made on or after January 1, 2003.¹⁹³ However, during the 2001-2002 session, the legislature extended the program's sunset date to January 1, 2004.¹⁹⁴ The program focuses on businesses with gross sales under \$5,000,000 and that primarily operate in the following industries: manufacturing, processing, warehousing, research and development, and service-related industries.¹⁹⁵ Taxpayers have requested credits in excess of available credits in four of the program's five-year existence.

2. Program Performance

Taxpayers have requested \$45,633,344 in tax credits since the program's inception through taxable year 2001.¹⁹⁶ These credits equate to approximately \$182,533,376 in corresponding investments into qualified businesses,¹⁹⁷ and the qualified investments during taxable years 1999 through 2001 have created approximately 3,400 jobs.¹⁹⁸ These new jobs' average wages are approximately \$36,870, \$53,429, and \$63,932 for taxable years 1999, 2000, and 2001 respectively.¹⁹⁹ Tables 14(a) and 14(b) below summarize the program's performance.

¹⁹² 1987 N.C. Sess. Laws 852.

¹⁹³ 1998 N.C. Sess. Laws 212.

¹⁹⁴ 2002 N.C. Sess. Laws 99.

¹⁹⁵ *See supra* note 192.

¹⁹⁶ *See infra* Table 14(a).

¹⁹⁷ *Id.*

¹⁹⁸ *See infra* Table 14(b).

¹⁹⁹ *Id.*

Table 14(a): North Carolina Qualified Business Investments Tax Credit Program

| Year | Tax Credits Requested ^(a) | # of Taxpayers Claiming Credit ^(a) | Corresp. Investment Amount ^(b) | Companies Receiving Investment | Avg. Size of Taxpayers' Investment ^(c) | Avg. Size of Tax Credit Claimed ^(d) | Avg. Size Investment Received by Business ^(e) |
|--------|--------------------------------------|---|---|--------------------------------|---|--|--|
| 1997 | \$5,344,641 | 635 | \$21,378,564 | n/a | \$33,667 | \$8,417 | n/a |
| 1998 | 6,450,000 | 402 | 25,800,000 | n/a | 64,179 | 16,045 | n/a |
| 1999 | 7,016,027 | 450 | 28,064,108 | n/a | 62,365 | 15,591 | n/a |
| 2000 | 18,997,004 | 975 | 75,988,016 | n/a | 77,936 | 19,484 | n/a |
| 2001 | 7,825,672 | 609 | 31,302,688 | n/a | 51,400 | 12,850 | n/a |
| Totals | \$45,633,344 | 3071 | \$182,533,376 | n/a | \$59,438 | \$14,859 | n/a |

n/a = North Carolina Department of Revenue does not track this information

^(a) North Carolina Department of Revenue

^(b) Calculated by dividing Total Tax Credits Requested by 25%

^(b) Calculated by dividing Total Tax Credits Requested by 25%

^(c) Calculated by dividing Corresp. Investment Amount by # of Taxpayers Claiming Credit.

^(d) Calculated by dividing Total Credits Claimed by # of Taxpayers Claiming Credit.

^(e) Calculated by dividing Corresp. Investment Amount by Companies Receiving Investment.

**Table 14(b): North Carolina Qualified Investment Tax Credit Program
Economic Development Statistics**

| | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|-------------|-------------|----------|--------|----------|
| Number of jobs created ^{(a) (b)} | Unavailable | Unavailable | 611 | 1,320 | 1,470 |
| Total average wages paid ^{(a) (b)} | Unavailable | Unavailable | \$36,870 | 53,429 | \$63,932 |

^(a) North Carolina Secretary of State, Securities Division, Annual Reports to the Legislative Research Commission dated December 2002, October 2001, and October 2000.

^(b) Note: The 2001 figures represent the time period from March 15, 2001, until March 15, 2002. The 2000 figures represent the time period from March 15, 2000, until March 15, 2001. The 1999 figures represent the time period from October 1999 through October 2000.

3. Program Administrator

The Securities Division of the North Carolina Secretary of State administers the program.

4. Aggregate Tax Credits Available Under the Angel Program

The program provides \$6,000,000 in available tax credits each calendar year,²⁰⁰ and it is of perpetual continuation until the legislature discontinues the program.

5. Percentage of a Qualified Investment Eligible for the Tax Credit

The program provides a state income tax credit in the amount of 25% of a qualified investment.²⁰¹

6. Qualified Businesses

The program defines a qualified business as a qualified business venture or a qualified grantee business. “A qualified business venture is a business that engages primarily in manufacturing, processing, warehousing, research and development, or a service-related industry, and is registered with the [program administrator].”²⁰² A business meets these requirements if all of the following are true as of the date the business files the application with the administrator:

- (1) The business “was organized after January 1 of the calendar year in which its application is filed,” or the business had gross revenues of \$5,000,000 or less on a consolidated basis according to generally accepted accounting principles during its most recent fiscal year before filing the application;²⁰³
- (2) The business “is organized to engage primarily in manufacturing, processing, warehousing, wholesaling, research and development, or a service-related industry”;²⁰⁴
- (3) The business “does not engage as a substantial part of its business in ... providing a professional service ...,” “construction or contracting,”

²⁰⁰ N.C. GEN. STAT. § 105-163.012(b) (2001).

²⁰¹ *Id.* § 105-163.011(b).

²⁰² *Id.* § 105-163.010(8).

²⁰³ *Id.* § 105-163.013(b)(1b).

²⁰⁴ *Id.* § 105-163.013(b)(3).

selling or leasing at retail,” dealings in commercial paper or other investments, “providing personal grooming or cosmetics services,” or “offering any form of entertainment, amusement, recreation, or athletic or fitness activity for which an admission or a membership is charged”;²⁰⁵

(4) The business was “not formed for the primary purpose of acquiring all or part of the stock or assets of one or more existing businesses”;²⁰⁶ and

(5) The business “is not a real estate-related business.”²⁰⁷

A qualified grantee business is a business that (1) “has received during the preceding three years a grant or other funding from” the North Carolina Technological Development Authority, the North Carolina Technological Development Authority, Inc., North Carolina First Flight, Inc., the North Carolina Biotechnology Center, the Microelectronics Center of North Carolina, the Kenan Institute for Engineering, Technology and Science, or the Federal Small Business Innovation Research Program, and (2) is registered with the program administrator.²⁰⁸

7. Application and Certification of a Qualified Business

A qualified business must file an application with the administrator showing that the business meets the requirements as a qualified business.²⁰⁹ The filing fee for a registration as a qualified business is \$100.²¹⁰ The administrator will disallow tax credits for investments made before a qualified business’s registration effective date.²¹¹ A business may sell or otherwise transfer its registration as a qualified business only if it “enters into a merger, conversion, consolidation, or other similar

²⁰⁵ *Id.* § 105-163.013(b)(4).

²⁰⁶ *Id.* § 105-163.013(b)(5).

²⁰⁷ *Id.* § 105-163.013(b)(6).

²⁰⁸ *Id.* § 105-163.010(9).

²⁰⁹ *Id.* §§ 105-163.013(b) and (c).

²¹⁰ *Id.* § 105-163.013(d).

²¹¹ *Id.* § 105-163.013(c).

transaction with another business and the surviving company [otherwise meets] the criteria” of a qualified business.²¹²

8. Administrative Disclaimer

The program does not provide a disclaimer regarding the North Carolina Secretary of State’s administration of the program.

9. Qualified Investments

A qualified investment is a direct purchase of a qualified business’ equity securities or subordinated debt from that business.²¹³ The taxpayer may use money or property other than money to make the qualified investment.²¹⁴ An equity security is “[c]ommon stock, preferred stock, or an interest in a partnership, or subordinated debt that is convertible into, or entitles the holder to receive upon its exercise, common stock, preferred stock, or an interest in a partnership.”²¹⁵ Subordinated debt is “[i]ndebtedness that is not secured and is subordinated to all other indebtedness of the [qualified business] issued or to be issued to a financial institution,” and “any portion of the indebtedness that matures earlier than five years after its issuance is not subordinated debt.”²¹⁶ Also, the “purchase of equity securities or subordinated debt [in which] a broker’s fee or commission or other similar remuneration is paid or given directly or indirectly for soliciting the purchase” does not qualify for the credit.²¹⁷

10. Taxpayers Eligible to Claim the Tax Credit

An individual or pass-through entity that makes a qualified investment is eligible to claim the credit.²¹⁸ Table 14(c) below illustrates the number of taxpayers

²¹² *Id.* § 105-163.013(f).

²¹³ *Id.* § 105-163.011(b).

²¹⁴ *See id.* § 105-163.011(c).

²¹⁵ *Id.* § 105-163.010(4).

²¹⁶ *Id.*

²¹⁷ *Id.* § 105-163.011(a).

²¹⁸ *Id.* §§ 105-163.011(b) and (b1).

approved by the administrator to claim the credit. However, a pass-through entity is ineligible to request the credit if it (1) “has committed capital under management in excess of [\$5 million]” or if it (2) “is a qualified grantee business, a qualified business venture, or a North Carolina Enterprise Corporation.”²¹⁹

| Table 14(c): Individual Taxpayers Approved for the Tax Credit ^(a) | | | | |
|---|------|------|------|------|
| 1997 | 1998 | 1999 | 2000 | 2001 |
| 635 | 502 | 450 | 975 | 609 |
| ^(a) North Carolina Department of Revenue | | | | |

A qualified taxpayer may not participate in the operation of the qualified business within three years of the investment date.²²⁰ Participation in the operation of a qualified business occurs “if the taxpayer, the taxpayer’s spouse, parent, sibling, or child, or an employee of any of these individuals or of a business controlled by any of these individuals, provides services of any nature to the [qualified business] for compensation, whether as an employee, a contractor, or otherwise.”²²¹ “However, a person who provides services to a qualified business ... as an officer, board member, or otherwise does not participate in its operations if the individual receives as compensation only reasonable reimbursement of expenses incurred in providing the services, participation in a stock option or stock bonus plan, or both.”²²²

11. Claiming the Tax Credit

Taxpayers must file the North Carolina Department of Revenue Form D-499, Application for Tax Credit for Qualified Business Investments, “on or before April 15 of the year following the calendar year” of investment to claim the credit.²²³ If a taxpayer made the investment with property other than money, the taxpayer must also include “a certified appraisal of the value of the property used to pay for the investment.”²²⁴ Although the Department of Revenue may grant extensions to

²¹⁹ *Id.* § 105-163.011(b1).

²²⁰ *Id.* § 105-163.014(a).

²²¹ *Id.*

²²² *Id.*

²²³ *Id.* § 105-163.011(c).

²²⁴ *Id.*

this deadline, it will not accept applications later than September 15 of the year following the calendar year of investment.²²⁵ Taxpayers must claim the credit on the tax return applicable to the calendar year in which the tax certificate becomes effective.²²⁶

An individual taxpayer's aggregate credit amount for one or more investments in a single taxable year, "whether directly or indirectly as owner of a pass-through entity, may not exceed [\$50,000]."²²⁷ "The aggregate amount of credit allowed a pass-through entity for one or more investments in a single taxable year ... may not exceed [\$750,000],"²²⁸ and "[e]ach individual who is an owner of a pass-through entity is allowed [a tax credit] in an amount equal to the owner's allocated share of the credits for which the pass-through entity is eligible"²²⁹ However, "[i]f an owner's share of the pass-through entity's credit is limited due to the \$50,000 maximum allowable credit ..., the pass-through entity and its owners may not reallocate the unused credit among the other owners."²³⁰

In the event that the requested tax credits exceeds a calendar year's available tax credits, the administrator allocates the available credits in proportion to the size of the credit amount requested by each taxpayer,²³¹ but the administrator must notify each taxpayer of the reduction of the allowable credit amount "on or before December 31 of the year following the calendar year in which" the taxpayer made the qualifying investment.²³² The administrator bases its allocation on timely filed

²²⁵ *Id.*; see also N.C. ADMIN. CODE tit. 17, r. 6B.0612. (Feb. 2003).

²²⁶ N.C. GEN. STAT. § 105-163.011(b).

²²⁷ *Id.* § 105-163.011(b).

²²⁸ *Id.* § 105-163.011(b1).

²²⁹ *Id.*

²³⁰ *Id.*

²³¹ *Id.* § 105-163.012(b).

²³² *Id.* § 105-163.012(c).

applications.²³³ This allocation is final, and the administrator will not subsequently adjust the allowable amounts for credits applied for by taxpayers but not claimed.²³⁴

Table 14(d) below illustrates that North Carolina taxpayers have requested credits in excess of the available credits in each of the last four years. The administrator's allocation of the available tax credits in these years has resulted in taxpayers receiving only a percentage of their requested credit amount as an allowable credit. As illustrated by the table, taxpayers' allowable credit as a percentage of taxpayers' requested amount has been 93.02%, 85.52%, 31.58%, and 76.67% for years 1998 through 2001, respectively.

| Table 14(d): N.C. Qualified Business Investment Tax Credits Claimed by Taxpayers | | | | | |
|---|-------------|-------------|-------------|--------------|-------------|
| | 1997 | 1998 | 1999 | 2000 | 2001 |
| Annual tax credits available ^(a) | \$6,000,000 | \$6,000,000 | \$6,000,000 | \$6,000,000 | \$6,000,000 |
| Total credits requested ^(a) | \$5,344,641 | \$6,450,000 | \$7,016,027 | \$18,997,004 | \$7,825,672 |
| Perc. request allowed as a tax credit ^(a) | 100% | 93.02% | 85.52% | 31.58% | 76.67% |
| ^(a) North Carolina Department of Revenue | | | | | |

Taxpayers must reduce their income tax liability by the sum of all other allowable tax credits before claiming the qualified investment tax credit,²³⁵ but taxpayers may carry forward any unused credit to the subsequent year for a period of up to five years.²³⁶ Furthermore, the \$50,000 limitation on the amount of credit taxpayers may claim “does not apply to unused amounts carried forward”²³⁷ Finally, taxpayers must reduce their basis in a qualified investment by the amount of any claimed credits attributable to a qualified investment.²³⁸

²³³ *Id.*

²³⁴ *Id.*

²³⁵ *Id.* § 105-163.012(a).

²³⁶ *Id.*

²³⁷ *Id.*

²³⁸ *Id.* § 105-163.012(d).

12. Required Holding Period of Qualified Investments

Taxpayers may not receive a redemption from the qualified business with respect to the securities received within five years after the investment date,²³⁹ and taxpayers may not transfer any of the securities received in the qualified investment to another person or entity within one year after the investment date.²⁴⁰ Exceptions to this holding requirement include a transfer resulting from (1) taxpayer death, (2) “a final distribution in liquidation to the owners of a [qualified business] that is a corporation or other entity,” or (3) “merger, conversion, consolidation, or similar transaction requiring approval by the owners of the [qualified business] under applicable state law to the extent that the taxpayer does not receive cash or tangible property” in the transaction.²⁴¹

13. Allowable Return on Investment

The program does address whether qualified taxpayers may receive a return on investment during the qualified investment’s holding period.

14. Forfeiture and Recapture of the Credit

Taxpayers are subject to forfeiture of future and previously issued tax credits if they do not comply with the nonparticipation and holding period requirements. More specifically, “taxpayer[s] who [forfeit] the credit ... [are] liable for all past taxes avoided as a result of the credit plus interest ... computed from the date the taxes would have been due.”²⁴² The past taxes and interest are due thirty days after the date of forfeiture.²⁴³ The program requires forfeiture of the tax credit in the following scenarios:

- (1) The taxpayer “participates in the operations of the [qualified business]” within three years after the investment date;²⁴⁴

²³⁹ *Id.* § 105-163.014(d)(2).

²⁴⁰ *Id.* § 105-163.014(d)(1).

²⁴¹ *Id.*

²⁴² *Id.* § 105-163.014(e).

²⁴³ *Id.*

²⁴⁴ *Id.* § 105-163.014(a).

- (2) The administrator revokes the qualified business registration “because information in the registration application was false at the time” of application;²⁴⁵
- (3) The “taxpayer transfers any of the securities received in the qualified investment ... to another person or entity” within one year after the investment date;²⁴⁶ or
- (4) The qualified business “makes a redemption with respect to the securities received in the investment” within five years after the investment date.²⁴⁷

15. Administrator Reporting Requirements

The administrator must “report to [North Carolina’s] Revenue Laws Study Committee by October 1 of each year all of the business that have registered with the [administrator] as [qualified business]”.²⁴⁸ In its report, the administrator must include the name, address, and, if different, the locations of headquarters and principle place of business of each qualified business, “a detailed description of the types of business in which it engages, whether the business is a minority business ..., the number of jobs created by the business during the period covered by the report, and the average wages paid by these jobs.”²⁴⁹

16. Qualified Business Reporting Requirements

A qualified business annually must renew its registration as a qualified business with the Department of Revenue,²⁵⁰ and the filing fee for registration renewal is

²⁴⁵ *Id.* § 105-163.014(b).

²⁴⁶ *Id.* § 105-163.014(d)(1).

²⁴⁷ *Id.* § 105-163.014(d)(2). Forfeiture of a credit does not occur if a qualified business that engages primarily in motion picture film production makes a redemption with respect to securities received in an investment and the following conditions are met: (1) the redemption occurred because the qualified business completed production of a film, sold the film, and was liquidated, and (2) neither the qualified business nor a related person continues to engage in business with respect to the film produced by the qualified business. *Id.* § 105-163.014(d1).

²⁴⁸ *Id.* § 105-163.013(g).

²⁴⁹ *Id.*

²⁵⁰ *Id.* § 105-163.013(c).

\$50.²⁵¹ More specifically, a qualified business renews its registration by filing an application that includes a financial statement for the most recent fiscal year showing gross revenues of \$5,000,000 or less on a consolidated basis, as determined in accordance with generally accepted accounting principles.²⁵² Further, the administrator will not approve a qualified business’s renewal of registration unless the qualified business also includes (1) whether the applicant is a minority business, (2) the number of jobs the business created during the preceding year that are attributable to the qualified investments, and (3) the average wages paid by each job.²⁵³

If a qualified business fails to renew its registration, the administrator may revoke its “registration effective as of the next day after the renewal deadline, but [revocation does] not result in a forfeiture of the tax credits previously allowed to taxpayers”²⁵⁴ If a qualified business fails to renew its registration but subsequently seeks to reinstate its registration within thirty days after receipt of its revocation notice, it must pay a \$1,000 late filing fee.²⁵⁵ A qualified business “that seeks approval of a new application for registration after the administrator has revoked its registration” also must pay a \$1,000 penalty.²⁵⁶ However, a business cannot lose its registration “solely because it ceases business operation for an indefinite period of time, as long as the business renews its registration each year”²⁵⁷

17. Lessons Learned

North Carolina’s tax credit program creates taxpayer inability to timely determine allowable credit amount. More particularly, if taxpayers request credits exceeding a year’s available credits, the program does not require the administrator to notify individual taxpayers of a reduction in allowable credit amount until December

²⁵¹ *Id.* § 105-163.013(d).

²⁵² *Id.* §§ 105-163.013(b)-(c).

²⁵³ *See id.* § 105-163.013(g).

²⁵⁴ *Id.* §105-163.013(b).

²⁵⁵ *Id.*

²⁵⁶ *Id.*

²⁵⁷ *Id.* § 105-163.013(e).

31 of the year following the calendar year of the qualified investment. Taxpayers must file their returns as if they will receive the full credit amount requested and subsequently amend their returns if the administrator lowers the allowable credit amount used on the tax return. However, a requirement for taxpayers to register a qualified investment with the administrator within thirty days of the investment date would reduce the administrative delay associated with allocating the available amount of credits. This alternative would therefore allow the administrator to determine whether the amount of requested credits will exceed the amount of available credits within thirty days after a calendar year's end, and the administrator could then make any required allocation and notify taxpayers before their respective state tax return filing deadlines.

C. Ohio's Technology Investment Tax Credit Program

1. Overview

Ohio touts its Technology Investment Tax Credit Program, enacted in 1996,²⁵⁸ as an “integral part of [its] economic development strategy”²⁵⁹ More specifically, the legislature designed the program to provide “businesses and individuals an additional incentive to invest in the state’s small, research and development, and technology-oriented firms.”²⁶⁰ These small businesses must have gross revenues less than \$1,000,000 to participate in the program.²⁶¹

2. Program Performance

Ohio taxpayers have claimed tax credits in the amount of \$4,559,176 since the program’s inception in 1996 through taxable year 2001, and these tax credits correspond to \$18,176,704 in qualified investments.²⁶² As of 2001, 43 qualified

²⁵⁸ 1996 Ohio Laws 18.

²⁵⁹ OHIO DEP’T OF DEV., OHIO’S TECHNOLOGY INVESTMENT TAX CREDIT PROGRAM: APPLICATION GUIDELINES, PROCESS & INSTRUCTION PACKET 1 (2003), *available at* <http://www.odod.state.oh.us/tech/titc> (indicating validity from January 2003 to July 31, 2003) [hereinafter OHIO DEP’T OF DEV.].

²⁶⁰ *Id.*

²⁶¹ *Id.* at 5.

²⁶² *See infra* Table 15.

businesses received qualified investments.²⁶³ Table 15 below summarizes the program’s performance in more detail.

3. Program Administrator

Ohio’s Industrial Technology Enterprise Advisory Council (the “Council”) administers the program, and the Edison technology centers assist in screening qualified businesses and eligible taxpayers.²⁶⁴ The Edison centers are “cooperative research and development facilit[ies]” located throughout the state “that receive[] funding through [Ohio’s] Thomas Alva Edison grant program.”²⁶⁵

Table 15: Ohio Technology Investment Tax Credit Program

| Year | Tax Credits Issued ^(a) | # of Taxpayers Claiming Credit | Corresp. Investment Amount ^(b) | Companies Receiving Investment ^(a) | Avg. Size of Taxpayers' Investment ^(c) | Avg. Size of Tax Credit Claimed ^(d) | Avg. Size Investment Received by Business ^(e) |
|---------------------|-----------------------------------|--------------------------------|---|---|---|--|--|
| 1996 | 312,500 | n/a | 1,250,000 | 2 | n/a | n/a | 625,000 |
| 1997 | 909,670 | n/a | 3,638,680 | 8 | n/a | n/a | 454,835 |
| 1998 | 88,568 | n/a | 354,272 | 3 | n/a | n/a | 118,091 |
| 1999 | 885,271 | n/a | 3,541,084 | 8 | n/a | n/a | 442,636 |
| 2000 | 1,204,839 | n/a | 4,819,356 | 11 | n/a | n/a | 438,123 |
| 2001 | 1,143,328 | n/a | 4,573,312 | 11 | n/a | n/a | 415,756 |
| 2002 ^(f) | 338,253 | n/a | 1,353,012 | 8 | n/a | n/a | 169,127 |
| Totals | \$4,882,429 | n/a | \$18,176,704 | 51 | n/a | n/a | \$356,406 |

n/a = information unavailable, Ohio Department of Taxation does not track this information.

Assumption: Tax Credits assumed issued in the same year that a Qualified Business is Certified; once a business is certified, tax credits may be issued for Qualified Investments made in years subsequent to certification.

^(a) Calculated based on Ohio Department of Development's Technology Investment Tax Credit Program List of Certified Businesses through July 31, 2002

^(b) Calculated by dividing Tax Credits Issued by the percentage of a qualified investment eligible for the credit (25%)

^(c) Calculated by dividing Corresp. Investment Amount by # of Taxpayers Claiming Credit.

^(d) Calculated by dividing Total Credits Claimed by # of Taxpayers Claiming Credit.

^(e) Calculated by dividing Corresp. Investment Amount by Companies Receiving Investment.

^(f) Tax credits issued through June 30, 2002

²⁶³ *Id.*

²⁶⁴ See OHIO DEP'T OF DEV., *supra* note 259, at 3.

²⁶⁵ OHIO REV. CODE ANN. §122.15(A) (Anderson 2003).

4. Aggregate Tax Credits Available Under the Tax Credit Program

The aggregate amount of available tax credits available under the program is \$10,000,000,²⁶⁶ but the program does not limit the amount of credits that taxpayers may claim in a single year.²⁶⁷

5. Percentage of a Qualified Investment Eligible for the Tax Credit

The program provides eligible taxpayers with a tax credit in the amount of 25% of a qualified investment.²⁶⁸

6. Qualified Businesses

A qualified business must meet the following requirements:

- (1) The qualified business must be a “corporation, limited liability company, or unincorporated business organization, including a general partnership or limited partnership . . .;”²⁶⁹
- (2) The qualified business’s principal place of business must be located within Ohio and must have at least 50% of its gross assets and employees located within the state;²⁷⁰
- (3) The qualified business must be in a “qualified trade or business”;²⁷¹

²⁶⁶ *Id.* § 122.15.1(D)(2).

²⁶⁷ *See* OHIO DEP’T OF DEV., *supra* note 259, at 3.

²⁶⁸ OHIO REV. CODE ANN. § 122.15.2(A).

²⁶⁹ *Id.* § 122.15(B).

²⁷⁰ *Id.* However, if the entity “is a member of an affiliated group, the gross assets and the number of employees of all members [of the group], wherever those assets and employees are located, shall be included for the purpose of determining the percentage of the [entity’s] gross assets and employees that are located in [Ohio].” *Id.* An “affiliated group” consists of “two or more persons related in such a way that one of the persons owns or controls the business operations of another of those persons.” *Id.* § 122.15(J).

²⁷¹ *Id.* §122.15.1 (A)(1). A “qualified trade or business” is “any trade or business that primarily involves research and development, technology transfer, bio-technology, information technology, or the application of new technology developed through research and development or acquired through

- (4) The qualified business must have less than \$1,000,000 of “gross revenue during its most recently completed fiscal year or [have] a net book value of less than [\$1,000,000] at the end of that fiscal year”,²⁷² and
- (5) The qualified business has not received more than an aggregate of \$1,000,000 in qualified investments.²⁷³

7. Application and Certification of a Qualified Business

The administrator must approve a business as a qualified business before the business’s receipt of a qualified investment.²⁷⁴ The business’s first step in this process is to submit an application, a business plan, and a \$150 fee to one of Ohio’s eight Edison Technology Centers, and the center must make its initial determination within three weeks regarding whether the business meets the criteria as a qualified business.²⁷⁵ The center then must send written notice of its initial determination to the administrator and to the applicant.²⁷⁶

The administrator must review the Edison center’s recommendation within four weeks of receipt.²⁷⁷ The administrator then may require the entity to submit additional information to support the application.²⁷⁸ At least two Council members must vote before the administrator can issue a final determination.²⁷⁹ Upon final determination, the administrator must send written notice of approval or disapproval to the applicant, the director of the Ohio Department of Development, and the

technology transfer.” *Id.* § 122.15(C). Businesses that are not included in the definition of a “qualified trade or business” are also specifically enumerated. *See id.*

²⁷² *Id.* § 122.15.1(A)(2).

²⁷³ *Id.* § 122.15.1(D)(1). *See also supra* note 266 and accompanying text.

²⁷⁴ *See* OHIO DEP’T OF DEV., *supra* note 259, at 3.

²⁷⁵ OHIO REV. CODE ANN. § 122.15.4(A).

²⁷⁶ *Id.*

²⁷⁷ *Id.*

²⁷⁸ *Id.* § 122.15.1(F).

²⁷⁹ *Id.*

respective Edison center.²⁸⁰ A qualified business remains eligible to receive qualified investments for a minimum of six months or until the end of the entity’s fiscal year, whichever is longer. Thereafter, the Edison centers and the administrator provide the qualified business a schedule to submit periodic reports to ensure that the qualified business remains eligible under the program.²⁸¹

8. Administrative Disclaimer

The program does not provide a disclaimer regarding the Edison center’s and the Council’s administration of the program.

9. Qualified Investments

A qualified investment is an investment that meets the following requirements:

- (1) A cash investment into a qualified business;²⁸²
- (2) “The investment takes the form of the purchase of common stock or preferred stock, a membership interest, a partnership interest, or any other ownership interest”;²⁸³
- (3) “The amount of the investment for which the credit is being claimed does not exceed” \$150,000;²⁸⁴ and
- (4) “The money invested is entirely at risk of loss, where repayment depends upon the success of the business operations” of the qualified business.²⁸⁵

²⁸⁰ *Id.*

²⁸¹ *Id.* §122.15.4(C).

²⁸² *See id.* § 122.15.1(A)(1).

²⁸³ *Id.* § 122.15.1(A)(3).

²⁸⁴ *Id.* § 122.15.1(A)(4).

²⁸⁵ *Id.* § 122.15.1(A)(5).

10. Taxpayers Eligible to Claim the Tax Credit

A taxpayer proposing to make a qualified investment must submit an application and a fee of \$200 to an Edison center before making the investment.²⁸⁶ The Edison center that receives the application must determine within three weeks whether the taxpayer qualifies for the tax credit, and center must then send written notice of its initial determination to the administrator and to the taxpayer.²⁸⁷ If the qualified business has not yet reached the \$1,000,000 limit and a taxpayer's application proposes an investment that will cause the qualified business to exceed the limit, the administrator will deny the taxpayer's application.²⁸⁸ The taxpayer may then amend the application to propose an investment amount that does not exceed the limit.²⁸⁹

Once a taxpayer receives notice of the administrator's approval, the taxpayer must make the investment within thirty days and then apply to the administrator for a tax credit certificate.²⁹⁰ The administrator requires the taxpayer to submit the following documents with the tax certificate application:

- (1) "A copy (front and back) of the [investor's] cancelled check";
- (2) "A copy of the bank's deposit slip (must have the bank's confirmation of the transaction specifically identifying each deposit by investor name and by the correct investment amount for that investor) If that is not available, [the administrator] will accept an official letter from the bank stating the investor's name, amount deposited, and the corresponding date of deposit for each investor.";
- (3) "A notarized letter from the company stating the date and amount" of the investment;
- (4) "A notarized letter from the investor clearly stating the date and amount of the investment"; and

²⁸⁶ *Id.* § 122.15.1(A).

²⁸⁷ *Id.*

²⁸⁸ *Id.* § 122.15.1(D)(1).

²⁸⁹ *Id.*

²⁹⁰ *Id.* § 122.15.2(A).

- (5) A dated, “newly issued stock certificate or other dated legal form of proof of ownership in the company (e.g. letter of subscription)”²⁹¹

Once the administrator “is satisfied that the taxpayer has made the investment in the proper form,” the administrator will issue the taxpayer a tax credit certificate indicating that the taxpayer is allowed a tax credit in an amount equal to 25% of the qualified investment.²⁹² However, the following taxpayers are ineligible to claim the credit:

- (1) Taxpayers delinquent in any state or local taxes;²⁹³
- (2) Taxpayers that make the investment before obtaining the administrator’s approval;²⁹⁴
- (3) Employees with “proprietary decision-making authority,” as determined by the administrator, in the qualified business or related to such an individual;²⁹⁵ and
- (4) Insiders of the qualified business.²⁹⁶

An insider is “an individual who owns, controls, or holds power to vote [5%] or more of the outstanding securities of a [qualified] business.”²⁹⁷ Additionally, to determine whether a taxpayer is an insider, “the percentage of voting power in the [qualified business] held by a person related to the [taxpayer] shall be added to the [taxpayer’s] percentage of voting power in the same [qualified business].”²⁹⁸

²⁹¹ *Id.*

²⁹² *Id.* § 122.15.2(A).

²⁹³ OHIO DEP’T OF DEV., *supra* note 259, at 3-4.

²⁹⁴ *See id.*

²⁹⁵ OHIO REV. CODE ANN. § 122.15.1(A)(8).

²⁹⁶ *Id.* § 122.15.1(A)(9).

²⁹⁷ *Id.* § 122.15(E).

²⁹⁸ *Id.* The taxpayer must have claimed the related person “as a dependent or a spouse on the [taxpayer’s] federal income tax return for the previous tax year.” *Id.*

11. Claiming the Tax Credit

A taxpayer may claim the credit amount indicated on the certificate against any state tax liability in the taxable year in which the administrator issued the certificate.²⁹⁹ To claim the tax credit, the taxpayer must attach a copy of the tax certificate to the appropriate tax return.³⁰⁰ A taxpayer's maximum credit relating to each tax credit certificate may not exceed \$37,500, and a taxpayer may not claim credits in excess of the taxpayer's state tax liability.³⁰¹ However, a taxpayer may carry forward any tax credit amount greater than the taxpayer's state tax liability for a period of up to 15 years.³⁰²

12. Required Holding Period of Qualified Investments

The taxpayer may not receive any repayment of qualified investment principal within three years of the qualified investment date.³⁰³

13. Allowable Return on Investment

A qualified business may provide the taxpayer dividend and interest payments in a collective amount that does not exceed 10% of the qualified investment during the three-year period subsequent to the investment date.³⁰⁴

14. Forfeiture and Recapture of the Credit

The Director of the Ohio Department of Development reserves the right to deny or cease a taxpayer's tax credit status if he or she determines that the entity in which the taxpayer proposes to invest, or has invested in after obtaining approval, is

²⁹⁹ *Id.* § 122.15.2(B). A taxpayer's "state tax liability" means any tax liability incurred under division (D) of section 5707.03, section[s] 5727.24, 5727.38, or 5747.02, or Chapter 5733 of the [Ohio Revised Code]." *Id.* § 122.15(H).

³⁰⁰ *Id.* § 122.15.2(D).

³⁰¹ Calculated by multiplying the maximum allowable investment relating to each tax credit certificate (\$150,000) by the percentage of a qualified investment eligible for the credit (25%).
See id. §§ 122.15.1(A)(4), 122.15.2 (A), 122.15.2 (B)(1)-(2).

³⁰² *Id.* § 122.15.2(B)(1).

³⁰³ *Id.* § 122.15.1(A)(6).

³⁰⁴ *Id.* § 122.15.1(A)(7).

not a qualified business.³⁰⁵ If the Director disapproves an application, the Director must “certify the action” with “written explanation” to the taxpayer(s), the entity, the Edison center that recommended the application, the administrator, and the Ohio Tax Commissioner.³⁰⁶ The Director, with the advice of the administrator, may also “adopt, amend, and rescind rules necessary to implement” the program.³⁰⁷

15. Administrator Reporting Requirements

The administrator must maintain a publicly accessible database indicating all approved entities eligible to receive qualified investments.³⁰⁸

16. Qualified Business Reporting Requirements

A qualified business must provide information as requested by the administrator to evaluate the effectiveness of the program.³⁰⁹

17. Lessons Learned

Ohio’s tax credit program has no annual limit on available credits. More particularly, Ohio provides the program an aggregate amount of available credits without limiting the amount of credits that taxpayers may collectively claim in any single year. This unrestricted amount of annual available credits prevents the state revenue department from accurately estimating a program’s impact on the state’s revenue collections for a particular taxable year. Consequently, a reduction in state revenue collections due to a substantial amount of credits claimed by taxpayers can have a significant impact on a state experiencing severe budget constraints. Further, without a limitation relating to the annual amount of available credits, taxpayers may exhaust the program’s available credits in a relatively few number of years.

³⁰⁵ *Id.* § 122.15.1(G).

³⁰⁶ *Id.*

³⁰⁷ *Id.*

³⁰⁸ *Id.* § 122.15.4(B).

³⁰⁹ OHIO DEP’T OF DEV., *supra* note 259, at 3.

D. Virginia's Qualified Equity and Subordinated Debt Investments Tax Credit

1. Overview

Virginia enacted its Qualified Equity and Subordinated Debt Investments Tax Credit program in 1998.³¹⁰ Under this program, taxpayers may invest in equity or subordinated debt in any business with gross revenues under \$5,000,000, excluding certain service-oriented businesses. During the 2001 legislative session, the Virginia General Assembly expanded the program effective for calendar year 2002.³¹¹ The amendment reduced the percentage of an investment eligible for the tax credit, increased the available tax credits per year, and reduced a qualified investment's holding period.³¹²

2. Program Performance

Virginia's program has proven very popular with investors. Taxpayers have requested a total of \$24,825,461 in credits, exceeding the amount of available credits each year since the program's inception.³¹³ The requested credits equate to approximately \$99,301,844 in corresponding qualified investments by at least 229 individuals into 200 qualified businesses through 2001. Table 16(a) summarizes the program's performance.³¹⁴

³¹⁰ 1998 Va. Acts ch. 491.

³¹¹ See H.B. 2466, 2001 Gen. Assem., Reg. Sess. (Va. 2001)(amending VA. CODE ANN. §58.1-339.4).

³¹² *Id.*

³¹³ See 2002-2004 BIENNIUM, *supra* note 90.

³¹⁴ See *infra* Table 16(a).

Table 16(a): Virginia Qualified Equity and Subordinated Debt Tax Credit Program

| Year | Tax Credits Requested ^(a) | # of Taxpayers Claiming Credit ^(a) | Corresp. Investment Amount ^(b) | Companies Receiving Investment ^(a) | Avg. Size of Taxpayers' Investment ^(c) | Avg. Size of Tax Credit Claimed ^(d) | Avg. Size Investment Received by Business ^(e) |
|--------|--------------------------------------|---|---|---|---|--|--|
| 1999 | \$8,241,675 | 89 | \$32,966,700 | 62 | 370,412 | 92,603 | 531,721 |
| 2000 | 6,531,761 | 140 | 26,127,044 | 57 | 186,622 | 46,655 | 458,369 |
| 2001 | 10,052,025 | n/a | 40,208,100 | 81 | n/a | n/a | 496,396 |
| Totals | \$24,825,461 | 229 | \$99,301,844 | 200 | \$433,633 | \$108,408 | \$496,509 |

n/a = Information not yet available as of December 13, 2002, per Virginia Department of Taxation, Office of Fiscal Research.

^(a) Virginia Department of Taxation, Office of Fiscal Research

^(b) Calculated by dividing Tax Credits Requested by the percentage of a qualified investment eligible for the credit (50%)
Note: Virginia reduced the percentage to 25% for investments after January 1, 2002.

^(c) Calculated by dividing Corresp. Investment Amount by # of Taxpayers Claiming Credit.

^(d) Calculated by dividing Total Credits Requested by # of Taxpayers Claiming Credit.

^(e) Calculated by dividing Corresp. Investment Amount by Companies Receiving Investment.

3. Program Administrator

The Virginia Department of Taxation administers the program.³¹⁵

4. Aggregate Tax Credits Available Under the Angel Program

The program provides \$20 million in tax credits each year for taxable year beginning on or after January 1, 2002.³¹⁶ However, Virginia's budget constraints have reduced available tax credits to \$4 million for taxable years 2003 and 2004.³¹⁷ The program provided \$5 million in tax credits for taxable years beginning before December 31, 2001.³¹⁸

³¹⁵ VA. CODE ANN. § 58.1-339.4(G) (Michie 2003).

³¹⁶ See H.B. 2466, 2001 Gen. Assem., Reg. Sess. (Va. 2001) (amending VA. CODE ANN. § 58.1-339.4(E)).

³¹⁷ See 2002-2004 BIENNIAL, *supra* note 90.

³¹⁸ VA. CODE ANN. § 58.1-339.4(E).

5. Percentage of a Qualified Investment Eligible for Tax Credit

The program provides an allowable tax credit in an amount equal to 25% of a taxpayer's qualified investment made after January 1, 2002.³¹⁹ The program previously provided an allowable tax credit equal to 50% of a taxpayer's qualified investment made on or after January 1, 1999 but before January 1, 2002.³²⁰

6. Qualified Businesses

Two hundred qualified businesses have received qualified investments since the program's inception.³²¹ A qualified business must:

- (1) have "annual gross revenues of no more than [\$5,000,000] in its most recent fiscal year",³²²
- (2) be "domiciled in" Virginia;³²³
- (3) be "engaged in business primarily in or does substantially all of its production" in Virginia,³²⁴ and
- (4) not be "primarily engaged, [or organized to engage]," in certain types of businesses defined by statute, including banking, credit or finance, accounting, insurance, construction, and business consulting.³²⁵

³¹⁹ H.B. 2466, 2001 Gen. Assem., Reg. Sess. (Va. 2001) (amending VA. CODE ANN. § 58.1-339.4(B)).

³²⁰ VA. CODE ANN. § 58.1-339.4(B).

³²¹ See *infra* Table 16(b).

³²² VA. CODE ANN. § 58.1-339.4(A)

³²³ *Id.*

³²⁴ *Id.*

³²⁵ *Id.* Businesses specifically denied eligibility for qualified status under Virginia's program are maintained by the Virginia Department of Taxation.

| Table 16(b): Virginia's Qualified Equity and Subordinated Debt Tax Credit | | | |
|---|------|------|------|
| Taxable Year | 1999 | 2000 | 2001 |
| Businesses receiving qualified investments | 62 | 57 | 81 |
| Source: Virginia Department of Taxation, Office of Fiscal Research and Virginia Department of Taxation 2001 Fiscal Impact Statement for House Bill 2466 to amend the Qualified Equity and Subordinated Debt Tax Credit. | | | |

7. Application and Certification of a Qualified Business

Every business seeking certification as a qualified business must apply to the administrator by December 31 of the year that it requests certification.³²⁶ The business must apply at least 90 days before its issuance of any equity or subordinated debt to ensure that the administrator can determine the entity's qualification before the issuance date.³²⁷ The administrator will not accept qualified business applications subsequent to the issuance of any equity or subordinated debt, except in certain instances.³²⁸ Once the administrator approves the business, it will issue a qualified business certificate that only is valid for the calendar year of issuance.³²⁹ The qualified business then must reapply each year for a new certificate.³³⁰

8. Administrative Disclaimer

The program does not provide a disclaimer regarding the Department of Taxation's administration of the program.

³²⁶ 23 VA. ADMIN. CODE § 10-110-227(A) (West 2002).

³²⁷ *Id.* § 10-110-227(A)(1).

³²⁸ *Id.* § 10-110-227(B). The only applicable instance where the Department of Taxation will accept a qualified business application after the issuance of any equity or subordinated debt is the issuance of "equity or subordinated debt on or after January 1, 2002, but within three months of the end of the most recently completed taxable year of the qualified business" *Id.* In this instance, the application must be "made by the first business day of the fourth month following the end of the most recently completed taxable year." *Id.*

³²⁹ *Id.* § 10-110-227(D).

³³⁰ See VA DEP'T OF TAXATION, FORM QBA: APPLICATION FOR DESIGNATION AS A QUALIFIED BUSINESS FOR THE QUALIFIED EQUITY AND SUBORDINATED DEBT INVESTMENTS TAX CREDIT (2002).

9. Qualified Investments

A “qualified investment” generally is defined as “a cash investment in a qualified business in the form of equity or subordinated debt.”³³¹ “Equity” in a corporation is “common or preferred stock, regardless of class or series.”³³² In a limited liability company, the taxpayer’s membership interest is characterized as equity, so long as the interest cannot be “required or subject to an option” to be redeemed by the issuer “within five years from the date of issuance.”³³³ “Subordinated debt” is “indebtedness of a corporation, general or limited partnership, or a limited liability company that (i) by its terms required no repayment of principal for the first three years after issuance; (ii) is not guaranteed by any other person or secured by any assets of the issuer or any other person; and (iii) is subordinated to all indebtedness and obligations of the issuer to national or state-charted banking or savings and loan institutions.”³³⁴

A qualified investment does not include “existing investments or instruments that have been purchased, transferred, or otherwise obtained without providing new capital to a qualified business.”³³⁵ An investment that “would otherwise qualify for [the tax] credit” is not a qualified investment if the qualified business uses “50% or more of the qualified investment proceeds within one year of the investment date to retire or reduce debt or equity” incurred by the qualified business before the investment date.³³⁶ Further, an investment does not qualify if the taxpayer making the investment, or any of the taxpayer’s family members or affiliates, “receives or has received compensation ... from the qualified business in exchange for services provided ... as an employee, officer, director, manager, independent contractor, or otherwise in connection with or within one year before or after the date of [the taxpayer’s] investment.”³³⁷

³³¹ VA. CODE ANN. § 58.1-339.4(A) (Michie 2003).

³³² *Id.*

³³³ *Id.*

³³⁴ *Id.*

³³⁵ 23 VA. ADMIN. CODE § 10-110-225 (West 2002).

³³⁶ *Id.*

³³⁷ VA. CODE ANN. § 58.1-339.4(A).

10. Taxpayers Eligible to Claim the Tax Credit

Individuals, estates, and trusts may claim the credit.³³⁸ Partnerships, S-corporations, and limited liability companies also may make qualified investments and then distribute the allowable tax credits to individual taxpayer-owners.³³⁹ Taxpayers making a qualified investment during a calendar year must submit a tax credit request and supporting documentation to the administrator no later than April 1 of the subsequent calendar year.³⁴⁰ Requests submitted by partnerships, S-corporations, and limited liability companies must include supporting documentation providing the name, address, and social security number of each of its individual partners, shareholders, or members and a statement as to how the entity will distribute any allowable credit.³⁴¹

11. Claiming the Tax Credit

The administrator must review all taxpayer requests for credits for completeness and notify taxpayers of any errors no later than June 1.³⁴² Taxpayers then have until June 15 to respond to any notices.³⁴³ The administrator must notify each eligible taxpayer by June 30 as to the taxpayer's allowable tax credit for the requested taxable year.³⁴⁴ In the case of a partnership, S corporation, or limited liability company, the administrator will send notification of the allowable tax credit to the entity.³⁴⁵ The individual taxpayers will then include a copy of the notification with their respective tax returns.³⁴⁶ In the event that an eligible taxpayer must file an individual state income tax return before receipt of the tax credit notification, the

³³⁸ See *id.* § 58.1-339.4.

³³⁹ See 23 VA. ADMIN. CODE § 10-110-228(C)(5).

³⁴⁰ *Id.* § 10-110-228(A).

³⁴¹ *Id.* § 10-110-228(C)(5).

³⁴² *Id.* § 10-110-228(D).

³⁴³ *Id.*

³⁴⁴ *Id.* § 10-110-228(E).

³⁴⁵ *Id.* § 10-110-228(E)(1).

³⁴⁶ *Id.*

taxpayer must either file the appropriate extension or file the return by the due date and then amend the return after receipt of the credit certification.³⁴⁷

A taxpayer's claimed tax credit amount for each year may not exceed the lesser of the taxpayer's tax liability for the respective taxable year or an amount equal to 10% of the aggregate amount tax credits available during the respective tax year.³⁴⁸ However, for taxable years beginning before December 31, 2001, a taxpayer's annual tax credit amount was limited to the lesser of the taxpayer's tax liability for the respective taxable year or \$50,000.³⁴⁹ This difference effectively increases an individual's potential annual credit limit to \$2,000,000 assuming the full \$20,000,000 of credits are available. However, Virginia's reduction in the amount of available credits due to budget constraints reduces a taxpayer's potential credit to \$400,000 for 2002. A taxpayer may carry forward any unused portion of the credit to the succeeding tax year for a period of up to 15 years.³⁵⁰ In the event that the total eligible credit requests exceed the statutory fiscal limitation, the administrator will grant each taxpayer a pro-rated share of the allowable credits for the respective tax year.³⁵¹

Taxpayers have requested credits in excess of the available credits each year since the program's inception. The administrator's allocation of the available tax credits in these years have resulted in taxpayers receiving only a percentage of their requested credit amount as a allowable credit.³⁵² A taxpayer's allowable credit as a percentage of the requested amount has been 60.67%, 76.54%, and 49.74% for years 1999 through 2001, respectively.³⁵³ Table 16(c) below provides a summary of the number of taxpayers claiming the credit and the allocation of the allowable tax credits.

³⁴⁷ *Id.* § 10-110-228(F).

³⁴⁸ H.B. 2466, 2001 Gen. Assem., Reg. Sess. (Va. 2001) (amending VA. CODE ANN. § 58.1-339.4(D)).

³⁴⁹ VA. CODE ANN. § 58.1-339.4(D) (Michie 2003).

³⁵⁰ *Id.*

³⁵¹ *Id.* § 58.1-339.4(G).

³⁵² *See infra* Table 16(c).

³⁵³ *Id.*

| Table 16(c): Virginia Taxpayers Claiming the Qualified Equity and Subordinated Debt Investments Tax Credit | | | |
|---|-------------|-------------|--------------|
| Taxable Year | 1999 | 2000 | 2001 |
| Taxpayers claiming the tax credit | 89 | 140 | n/a |
| Statutory cap on available credits | \$5,000,000 | \$5,000,000 | \$5,000,000 |
| Total credits requested | \$8,241,675 | \$6,531,761 | \$10,052,025 |
| % of request allowed as a tax credit | 60.67% | 76.54% | 49.74% |
| n/a = Information not yet available as of December 13, 2002. Source: Virginia Department of Taxation, Office of Fiscal Research. | | | |

12. Required Holding Period of Qualified Investments

A taxpayer must hold the equity interest received in connection with a qualified business investment for at least two full calendar years.³⁵⁴ Exceptions to this holding requirement are “the liquidation of the qualified business issuing [the] equity”; a “merger, consolidation or other acquisition of [the] business with or by a party not affiliated with [the] business”; or “death of the taxpayer.”³⁵⁵ In any event, a taxpayer must hold subordinated debt for 3 years.³⁵⁶

13. Allowable Return on Investment

The program does address whether an individual may receive a return on investment during the qualified investment’s holding period.

14. Forfeiture and Recapture of the Credit

If the taxpayer does not meet a qualified investment’s required holding period, then the administrator will assess a 100% penalty on the prior credits claimed, plus interest amounting to 1% per month compounded monthly from the

³⁵⁴ H.B. 2466, 2001 Gen. Assem., Reg. Sess. (Va. 2001) (amending VA. CODE ANN. § 58.1-339.4(F)).

³⁵⁵ VA. CODE ANN. § 58.1-339.4(F) (Michie 2003).

³⁵⁶ *Id.* § 58.1-339.4(A).

date the taxpayer claimed the credit.³⁵⁷ Upon written request, the administrator discretionarily may abate an “assessed penalty, in full or in part, if the [taxpayer] establishes reasonable cause for failure to hold the qualified investment for the required holding period.”³⁵⁸

15. Administrator Reporting Requirements

The program does not require the administrator to report the program’s performance information.

16. Qualified Business Reporting Requirements

Upon issuance of equity or subordinated debt, a qualified business must issue a statement to each taxpayer for attachment to the taxpayer’s tax credit application.³⁵⁹ The statement to the taxpayer must include the qualified business certification granted by the administrator; the type of investment at issue (that is, equity or subordinated debt) and the amount; and that the investment at issue meets the definition of a qualified investment.³⁶⁰ Virginia’s Administrative Tax Code also requires additional language depending on whether the investment at issue is equity or subordinated debt.³⁶¹

17. Lessons Learned

It is theoretically possible for a relatively few number of qualified investments to exhaust a program’s annual amount of available credits. Virginia’s program limits a taxpayer’s claimable credit amount to the lesser of the taxpayer’s tax liability or an amount equal to 10% of the aggregate amount of tax credits available in the respective tax year. This 10% claimable credit amount restriction creates the possibility that only ten qualified investments are necessary to exhaust the annual amount of available credits, assuming that the respective taxpayers’ tax liabilities exceed 10% of the annual available credits. In 1999 and 2000, the latest available

³⁵⁷ 23 VA. ADMIN. CODE § 10-110-229(E) (West 2002).

³⁵⁸ *Id.* § 10-110-229(F).

³⁵⁹ *Id.* § 10-110-227(E).

³⁶⁰ *Id.*

³⁶¹ *See id.* § 10-110-227(E)(a)-(b).

information, 89 and 140 taxpayers made qualified investments, respectively.³⁶² Finite limitations regarding the maximum amount of a qualified investment or the amount of credit that a taxpayer may claim in any single year, however, would substantially increase the number of qualified investments necessary to exhaust the annual amount of available credits.

In addition, Virginia's administrative procedures prevent taxpayers from determining their allowable credit amount or when they will actually receive the allowable credit. The Department of Taxation does not determine whether taxpayers' requests for tax credits exceed the calendar year's aggregate limit until June of the following calendar year. If the credit requests exceed the year's available credits, the Department of Taxation will pro-rate the available tax credits among the eligible taxpayers. A taxpayer making a January 2002 qualified investment is unable to determine the respective tax credit amount until receipt of the Department of Taxation's notification in June 2003. Further, the Department of Taxation does not notify taxpayers regarding their allowable tax credit amount until after the taxpayer's filing deadline. Taxpayers therefore must file their returns as if they will receive the full amount requested. If a taxpayer's subsequent allowable tax credit amount differs from the amount included on the taxpayer's tax return, however, the taxpayer must amend and re-file their taxes within the applicable statute of limitations.

E. Iowa's Angel Investor Tax Credit

1. Overview

Iowa enacted its program Tax Credits for Investments in Qualifying Business and Community-Based Seed Capital Funds program in February 2002, and the Iowa legislature anticipates that the new program will encourage investments in Iowa's early stage businesses, thereby increasing the "availability of and accessibility to venture capital, particularly at the seed capital investment stage."³⁶³ The program focuses on businesses fewer than three years old with sales less than \$3,000,000.³⁶⁴ The program does not confine qualified businesses to particular industries but specifically excludes the real estate, professional services, and health care

³⁶² See *supra* Table 16(c).

³⁶³ 2002 Iowa Acts 2271.

³⁶⁴ See generally *id.*

industries.³⁶⁵ The tax credits are available to individuals, corporations, banks, and insurance companies as an offset to their state income tax liabilities.³⁶⁶

2. Program Performance

Although there will not be data available until 2006 regarding the amount of tax credits claimed by taxpayers, the legislature anticipates that demand and level of investments will be sufficient to use all \$10,000,000 in available tax credits.³⁶⁷

3. Program Administrator

Iowa's newly formed Iowa Capital Investment Board (the "Board") will administer the program.³⁶⁸ The program requires the Board to develop a system of registration, authorization, and distribution of the tax credits.³⁶⁹ The Board recently proposed the program's final rules and regulations, subject to confirmation of the Administrative Rules Review Committee.³⁷⁰ Once approved, the final administrative rules and regulations will become effective January 1, 2003, and the administrator therefore is not accepting applications for certification as a qualified business until January 1, 2003.³⁷¹ The program also authorizes the administrator to cooperate with the Iowa's small business development centers to "disseminate information regarding the availability of [the] tax credits" and to "develop a standard seed capital application form that the small business development centers may submit to the [B]oard on behalf of clients seeking capital."³⁷²

³⁶⁵ *Id.*

³⁶⁶ *Id.*

³⁶⁷ *See id.* (citing Iowa Seed Capital Tax Credit Fiscal Note supplied by the Iowa Legislative Fiscal Bureau).

³⁶⁸ *See* 2002 Iowa Acts 2078.

³⁶⁹ 2002 Iowa Acts 2271.

³⁷⁰ Iowa Admin. Bull. XXV.

³⁷¹ Telephone Interview with Jim McNulty, Representative, Iowa Department of Commerce, (Dec. 3, 2002).

³⁷² 2002 Iowa Acts 2271.

4. Aggregate Tax Credits Available Under the Angel Program

The total amount of available tax credits available under the program is \$10,000,000, spread over three years.³⁷³ The aggregate amount of tax credits available for fiscal years beginning July 1, 2002, and July 1, 2003, is limited to \$3,000,000.³⁷⁴ The total available tax credits available for fiscal tax year beginning July 1, 2004, is limited to \$4,000,000.³⁷⁵

5. Percentage of a Qualified Investment Eligible for Tax Credit

The program provides a tax credit equal to 20% of an individual's equity investment into a qualified business or community-based seed capital fund.³⁷⁶

6. Qualified Businesses

A business must meet the following criteria in order to receive investments qualifying for the tax credit:

- (1) located in Iowa;³⁷⁷
- (2) in business no more than 3 years;³⁷⁸
- (3) owner with qualifying experience, education, or training;³⁷⁹

³⁷³ *Id.*

³⁷⁴ *Id.*

³⁷⁵ *Id.*

³⁷⁶ *Id.*

³⁷⁷ *Id.*

³⁷⁸ *Id.*

³⁷⁹ *Id.* An owner's qualifying experience, education, or training includes the following: (1) "an entrepreneurial venture development curriculum"; (2) "three years of relevant business experience"; (3) "a four-year college degree in business management, business administration, or a related field"; or (4) "other training or experience as the Iowa Capital Investment Board may specify by rule or order as sufficient to increase the probability of success of the qualifying business." *Id.*

- (4) not engaged in retail, real estate, health care, or other professional service business;³⁸⁰
- (5) net worth of less than \$3,000,000;³⁸¹ and
- (6) must raise at least \$250,000 total capital within 24 months after receiving the first investment qualifying for the tax credit.³⁸²

A “community-based seed capital fund” must meet the following criteria in order to receive investments qualifying for the tax credit.

- (1) “The fund is a limited partnership or limited liability company”;³⁸³
- (2) “The fund has, on or after January 1, 2002, a total of both capital commitments from investors and investments in qualifying businesses of at least [\$500,000], but not more than [\$3,000,000]”;³⁸⁴ and
- (3) The fund has at least “ten individual investors who are not affiliates, with no single investor and affiliates of that investor together owning a total of more than [25%] of the ownership interests outstanding in the fund.”³⁸⁵

7. Application and Certification of a Qualified Business

The program does not require a business to apply as a qualified business nor does it require the administrator to determine the eligibility of the business before receiving a qualified investment.³⁸⁶

³⁸⁰ *Id.*

³⁸¹ *Id.*

³⁸² *Id.*

³⁸³ *Id.*

³⁸⁴ *Id.*

³⁸⁵ *Id.*

³⁸⁶ *See generally id.*

8. Administrator Disclaimer

The program does not provide any disclaimer regarding the Board's administration of the program. However, a disclaimer is unnecessary because a taxpayer has made his or her investment into a business before the Board's determination of whether the business or community-based seed capital fund and the taxpayer qualify for participation in the program.

9. Qualified Investments

Only cash equity investments made after January 1, 2002, in a qualified business or a community-based seed capital fund qualify for the tax credit.³⁸⁷ Further, the qualified business receiving the investment must notify the administrator within 120 days of the date of the first investment of the names, addresses, and taxpayer identification numbers of all shareholders who may initially qualify for the tax credits, the shares issued, the consideration paid for the shares, the amount of any tax credits, and the earliest year in which the tax credits may be redeemed.³⁸⁸

10. Taxpayers Eligible to Claim the Tax Credit

Only natural persons are eligible to claim the tax credits relating to investments in qualified businesses.³⁸⁹ However, natural persons and various types of entities including corporations, limited liability companies, general and limited partnerships, and trusts, and estates are eligible for tax credits issued in relation to investments in community-based seed capital funds.³⁹⁰

Once the administrator receives notification from the qualified business, it will issue a taxpayer a tax credit certificate after it verifies the eligibility of the qualified business.³⁹¹ The tax certificate "contain[s] the taxpayer's name, address, tax identification number, the amount of the tax credit, the name of the [qualifying business] or community-based seed capital fund, and other information required" by

³⁸⁷ *Id.*

³⁸⁸ *Id.*

³⁸⁹ *See id.*

³⁹⁰ *See id.*

³⁹¹ *Id.*

the Iowa Department of Revenue and Finance.³⁹² An investor in a community-based seed capital fund can only receive a tax credit for that investor's investment in the fund and may not receive any additional tax credit for the investor's share of the fund's investment in a qualified business.³⁹³ An investor may, however, receive a tax credit "with respect to a separate direct investment made by the investor in the same qualified business in which the [fund] invests."³⁹⁴ Taxpayers that are current or previous owners, members, or shareholders in a qualified business are ineligible to claim the tax credit.³⁹⁵

11. Claiming the Tax Credit

The credit is available to the state's taxpayers against their net personal income tax liability in tax years beginning on or after January 1, 2002.³⁹⁶ However, due to Iowa's current budget shortfalls, a taxpayer may not claim the credit before the third tax year following the tax year in which the taxpayer made the qualifying investment.³⁹⁷ In other words, a taxpayer may not claim a tax credit for a qualified investment made during calendar year 2002 until 2005, the third taxable year following taxable year 2002. Therefore, taxpayers must wait until 2006 when they file their returns for taxable year 2005 to claim the tax credit.

A taxpayer and the taxpayer's affiliates may not claim credits for more than five different qualified investments in five different qualifying businesses.³⁹⁸ Further, a taxpayer's maximum credit amount relating to a qualified investment in any one qualifying business is \$50,000.³⁹⁹ Therefore, a taxpayer's maximum allowable tax

³⁹² *Id.*

³⁹³ *Id.*

³⁹⁴ *Id.*

³⁹⁵ *Id.*

³⁹⁶ *Id.*

³⁹⁷ *See id.*

³⁹⁸ *Id.* The term "[a]ffiliate" means a spouse, child, or sibling of an investor or a corporation, partnership, or trust in which an investor has a controlling equity interest or in which an investor exercises management control." *Id.*

³⁹⁹ *Id.*

credit per year is \$250,000.⁴⁰⁰ Although taxpayers may not claim credits in excess of their state tax liability, they may carry forward any credit amount in excess of the taxpayer's tax liability to the subsequent tax year until depleted for a period of up to 5 years.⁴⁰¹

12. Required Holding Period of Qualified Investments

The program does not specifically address a required holding period of qualified investments. However, the program effectively requires taxpayers to hold their investments for at least three years after the investment date.⁴⁰² This result occurs because of the fact that investors may not claim the tax credit until the third tax year after the date of investment, coupled with the requirement that qualified businesses and funds must report to the administrator any changes in the eligibility of its respective investors. A taxpayer not listed by a qualified business or fund as an eligible shareholder, partner, or member in the year in which the taxpayer is first able to claim the credit is therefore unable to claim the credit.

13. Allowable Return on Investment

The program does address whether an individual may receive a return on investment during the qualified investment's holding period.

14. Forfeiture and Recapture of the Credit

The administrator may rescind any tax credit certificates issued to the limited partners or members of a community-based seed capital fund in the event that a community-based seed capital fund either "fails to meet or maintain any requirements set forth in the program" or "has not invested at least [33%] of its invested capital in no fewer than two separate qualified businesses"⁴⁰³ However,

⁴⁰⁰ The program limits a taxpayer to 5 qualified investments and limits the corresponding credit for each qualified investment to \$50,000.

⁴⁰¹ 2002 Iowa Acts 2271.

⁴⁰² Assuming a taxpayer makes an investment on December 31, 2002, the taxpayer may not claim the credit until the third taxable year, or taxable year 2005, in which the taxpayer files the return in February 2006. *See id.*

⁴⁰³ 2002 Iowa Acts 2271.

a fund may apply to the administrator for a one-year waiver from these requirements.⁴⁰⁴

15. Administrator Reporting Requirements

The program requires the administrator to publish an annual report describing the program’s activities.⁴⁰⁵ This report must “include a listing of all qualified businesses and the number of tax credit certificates and the amount of the credits issued by the administrator.”⁴⁰⁶

16. Qualified Business Reporting Requirements

A qualified business must amend its list of shareholders that may qualify for the tax credits as the qualified business sells new equity securities or as any information on the list changes.⁴⁰⁷ Qualified business and community-based seed capital funds also must “notify the [administrator] in a timely manner of any changes regarding its qualification under the program or in the eligibility of its respective investors, limited partners, or members to redeem the tax credits in any year.”⁴⁰⁸ A community-based seed capital fund also must “notify the [administrator] in a timely manner of any changes in its qualifications of any qualified businesses in which the fund has invested.”⁴⁰⁹

17. Lessons Learned

First, Iowa’s delegation of the administration of its program to the Board minimizes the tracking, control, and administrative burdens on Iowa’s Department of Revenue and Finance. The legislature specifically authorizes, however, the administrator to cooperate with the state’s Small Business Development Centers in marketing the program and providing assistance to small businesses seeking

⁴⁰⁴ *Id.*

⁴⁰⁵ *Id.*

⁴⁰⁶ *Id.*

⁴⁰⁷ *Id.*

⁴⁰⁸ *Id.*

⁴⁰⁹ *Id.*

capital.⁴¹⁰ Second, the program delays the financial impact on the state by delaying the period in which a taxpayer may claim a credit until three years after the qualified investment date.

Third, on a critical note, the program limits a taxpayer and his affiliates' annual number of qualified investments to five. The inclusion of a taxpayer's affiliates in determining a taxpayer's number of qualified investments may effectively reduce the availability of venture capital to intended beneficiaries. A number of scenarios may exist in which an otherwise qualifying investment will be ineligible for the tax credit. For example, a father and each of his three daughters, all independent sophisticated businesspersons, invest into a collective six different qualified businesses. However, under the current program guidelines, only five of the six investments are eligible for the tax credit. Consequently, the program actually may provide a disincentive for one of the individuals to make an investment. The program could increase the number of angel investors available to a qualified business by redefining the affiliate definition to include only the taxpayer's claimed dependents. In essence, the current definition of an affiliate coupled with the \$50,000 cap on an investment in a qualifying business may unnecessarily deny an Iowa early-stage company a vital source of capital.

Fourth, as repeatedly noted, a taxpayer may not claim a tax credit before the third tax year following the tax year in which the taxpayer made the qualifying investment. However, the administrator may not issue the taxpayer a tax credit certificate until it verifies that a qualified business or fund has complied with the program requirements. For example, a qualified business must raise at least \$250,000 total capital within 24 months after receiving the first investment qualifying for the tax credit. This requirement requires a taxpayer to wait for the tax credit certificate until the business raises the required \$250,000 additional capital, invest more capital in the business to enable business to reach the benchmark, or, in a worst-case scenario, never claim the tax credit. A taxpayer also is subject to independent events during this three-year period relating to an investment in a seed fund. Therefore, a taxpayer can make a qualified investment and subsequently become ineligible to claim the credit despite the taxpayer's compliance with the intentions and requirements of the program.

⁴¹⁰ *Id.*

APPENDIX III. ANALYSIS OF THE PROPOSED PROGRAM SIMILARLY FORMATTED TO THE STATES SURVEYED

This section analyzes the proposed Tennessee Seed Capital Qualified Investment Tax Credit via the same categories used in analyzing the states surveyed in Appendix II.⁴¹¹

A. Program Administrator

The Tennessee General Assembly must appoint the program's administrator.

B. Available Tax Credits

The total amount of tax credits available to taxpayers under this program for investments made on or after January 1, 2004, but before January 1, 2005, shall not exceed \$3,000,000. The total amount of tax credits available to taxpayers under this program for each calendar year beginning on or after January 1, 2005, shall not exceed \$4,000,000. In the event that taxpayers do not request the total available tax credits in a given year, the administrator shall add remaining available tax credits to the subsequent year's available tax credits.

C. Tax Credit Amount as a Percentage of a Qualified Investment

The administrator may issue a qualified investment tax credit certificate in an amount not more than 25% of a qualified investment.

D. Qualified Businesses

A qualified business eligible to receive qualified investments must (1) be located in Tennessee; (2) be formed as a corporation, partnership, or limited liability company and in good standing and authorized to do business in Tennessee; (3) be the full-time, professional activity of at least one of the principal owners; (4) be fewer than 3 years old as of the date of application as a qualified business; (5) have annual gross sales of \$3,000,000 or less; and (6) be operating in a qualified trade or business.

A "qualified trade or business" is (1) any trade or business that primarily involves research and development, technology transfer, biotechnology, information technology, or the application of new technology developed through research and development or acquired through technology transfer or (2) any trade or business

⁴¹¹ The information contained herein primarily is drawn from Parts II, III, and IV of this Article.

that brings significant capital into Tennessee. In determining whether a business brings new capital into the state, the administrator will consider whether the investment (1) will create jobs within the state, (2) produce sales tax revenue for the state, and (3) results in new capital being brought into the state in an amount at least equal to the amount of the corresponding credit sought within 2 years of the granting of the credit.

A qualified trade or business does not include (1) any trade or business involving the performance of services in the field of law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial or 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; (2) any banking, insurance, financing, leasing, rental, investing, or similar business; or (3) any business operating a hotel, motel, restaurant, or similar business.

E. Application and Certification of Qualified Businesses

The administrator shall be responsible for developing qualified business applications, making applications available to businesses, and assisting businesses in preparing their applications. The application shall include at a minimum (1) general information identifying and describing the business, (2) the business's gross annual sales for the preceding year, (3) the business's formation date, and (4) the intended use of any qualified investment proceeds. The administrator shall not issue a tax credit certificate to a taxpayer corresponding to an investment in a business before the administrator's receipt of the business's qualified business application.

Businesses meeting the criteria of a qualified business shall file an application, a business plan, and a \$200 nonrefundable fee with the administrator. The administrator, within four weeks of receiving a completed application, shall determine whether the business is a qualified business and send the business either a qualified business certificate or written notice of the reasons the business does not meet the criteria of a qualified business. A qualified business may sell or otherwise transfer its qualified business certificate only if it enters into a merger, conversion, consolidation, or other similar transaction with another business and if the surviving company otherwise meets the criteria of a qualified business.

F. Administrative Disclaimer

The program administrator does not endorse a business or the prudence of an investment by certifying a qualified business or by issuing tax credit certificates. In addition, the administrator does not review the financial or business prospects of

any business or review or approve any materials used by the qualified business to solicit qualified investments.

G. Qualified Investments

A “qualified investment” is a cash investment that meets the following criteria:

- (1) The investment purchases the equity securities of a qualified business;
- (2) The purchase of the equity securities is not subject to a broker’s fee or commission or other similar remuneration paid or given directly or indirectly for solicitation of the purchase;
- (3) The investment is made under an agreement where the qualified business may not repay the investment to the taxpayer within 2 years of the date in which the qualified business receives the investment proceeds;
- (4) The investment must remain entirely at risk of loss and repayment of principal and any return must depend entirely upon the success of the qualified business; and
- (5) The qualified business must expend the entire proceeds of an eligible investment for plant, equipment, research and development, marketing and sales activity, or working capital for the business.

A qualified investment does not include existing investments that have been purchased, transferred, or otherwise obtained without providing new capital to a qualified business. A taxpayer’s aggregate qualified investment amount in one or more qualified businesses may not exceed \$200,000 per year, and a taxpayer’s cumulative qualified investment amount in any one qualified business may not exceed \$200,000.

H. Taxpayers Eligible to Claim the Tax Credit

Only natural persons are eligible to claim the credit. Taxpayers ineligible to claim the credit include (1) a principal owner or a spouse of a principal owner in a qualified business; (2) a family member of a principal owner if the person has any existing ownership interest in the qualified business; (3) a taxpayer, or any of the taxpayer’s family members or any entity affiliated with the taxpayer, that receives or

has received compensation from the qualified business in exchange for services provided to the business as an employee, officer, director, manager, consultant, independent contractor or otherwise in connection with or within 1 year before or after the date of the taxpayer's qualified investment; and (4) a taxpayer who participates in the operation of the qualified business within 2 years of the qualified investment date.

Taxpayers meeting the criteria of an eligible taxpayer shall file an investor application accompanied by a \$100 nonrefundable fee with the administrator. The administrator shall review the investor's application within 4 weeks after the submission of a completed application and issue a formal approval of tax credit status or reject the application. After receiving notice of approval from the administrator, a taxpayer, within a period of time determined by the administrator, may make the investment and apply to the administrator for a tax credit certificate. Upon the administrator's satisfaction that the taxpayer has made the investment in the proper form, it shall issue the taxpayer a tax credit certificate indicating that the taxpayer is allowed a tax credit in an amount equal to 25% of the qualified investment.

I. Claiming the credit

Taxpayers may claim the credit on the tax return applicable to the taxable year in which the taxpayer made the qualified investment. A taxpayer may claim the credit as a direct offset against 50% of the taxpayer's net state income tax liability. A taxpayer's net income tax liability is the taxpayer's income tax liability reduced by all other credits and exemptions. In the event that the allowable credit amount exceeds 50% of the taxpayer's net income tax liability, the taxpayer may claim any unused portion of the credit in the subsequent tax year for a period of up to 7 years. A taxpayer may combine any carry forward amount with all other qualified investment tax credits before applying the 50% net income liability test. The Tennessee Department of Revenue shall establish the guidelines that taxpayers must follow to claim the qualified investment tax credit.

In the event that taxpayers request credits in excess of the available credits, the administrator shall grant each taxpayer a pro-rated share of the available credits. The program administrator will base this allocation on timely filed applications and will not subsequently adjust the allowable amounts for credits applied for but not subsequently claimed by taxpayers. In the event of an allocation, the administrator shall notify the taxpayer of the amount of the reduction of allowable credit on or before January 31 of the year following the calendar year of the qualified investment date.

J. Holding Period of the Eligible Investment

A taxpayer may not transfer any of the securities received for the qualified investment within 2 years after the investment date. Exceptions to this holding requirement include a transfer resulting from (1) the death of the taxpayer, (2) a final distribution in liquidation to the owners of a qualified business that is a corporation or other entity, or (3) a merger, conversion, consolidation, or similar transaction requiring approval by the owners of the qualified business under applicable state law to the extent that the taxpayer does not receive cash or tangible property in the transaction.

K. Allowable Return on Investment

A qualified business may not make repayments to the taxpayer except for dividends during the two-year period following the investment date. The program does not limit the return on investment in the form of dividends that a taxpayer may receive during a qualified investment's required holding period.

L. Forfeiture and Recapture

A taxpayer shall recapture any previously claimed credits and forfeit any remaining unclaimed tax credit in certain circumstances: (1) administrative revocation of the qualified business certification because information in the registration application was false at the time the business filed the application; (2) material participation by a taxpayer in the operations of the qualified business within 2 years of the investment date; (3) a qualified business' redemption with respect to the securities received for the qualified investment within 2 years of the investment date; or (4) taxpayer transfer of any of the securities received in the qualified investment within 2 years of the investment date. The Department of Revenue may impose any applicable interest and penalties on the recaptured credits. The taxpayer must also pay the Department of Revenue a penalty in the amount of 25% of the total credit amount stated on the tax credit certificate.

M. Administrator Reporting Requirements

The administrator shall notify the Department of Revenue regarding any revocation or disallowances of tax credit certificates. The administrator shall maintain a publicly accessible list of certified qualified businesses, and the list shall include each qualified business's name, addresses, and the nature of the business.

The administrator and the Department of Revenue shall each issue an annual report to the Tennessee Department of Economic and Community Development (“ECD”) and to the General Assembly regarding the program’s activity. The respective reports shall reflect both the annual and cumulative figures for each line item, and the ECD shall make the reports available to the public via its website.

The administrator shall issue its annual report by the first business day of the third month following each calendar year. The report shall include the following information: (1) the number of entities applying for certification as a qualified business; (2) the number of entities certified as a qualified business; (3) the names and addresses of the entities certified as a qualified business; (4) the number of individuals applying for the tax credit; (5) the number of tax credit certificates issued; (6) the amount of tax credit certificates issued; (7) the number of investments made by taxpayers; (8) the amount of investments made by taxpayers; (9) the number of qualified businesses receiving qualified investments; (10) the number of jobs created by qualified businesses receiving qualified investments; and (11) the average amount of wages paid by these new jobs. The Department of Revenue shall issue its report by October 1 of each year, and the report shall include the number of taxpayers claiming the angel tax credit and the amount of credits claimed by taxpayers.

N. Qualified Business Reporting Requirements

Each qualified business that receives qualified investments shall file an annual report with the administrator no later than January 31 of each subsequent year that the business is certified as a qualified business. This report shall include (1) whether the applicant is a minority-owned business, (2) the number of jobs the business created during the preceding year, (3) the average wages paid, and (4) the preceding calendar year’s gross revenues. In the event that a qualified business fails to meet the program’s reporting requirements, the administrator shall revoke the qualified business certification and rescind the tax certificates attributable to the qualified investments made during the calendar year for which the report is required until the administrator receives the report. If the administrator does not receive the qualified business’s annual report by March 31, the administrator shall notify the Department of Revenue regarding the rescinded tax credit certificates.

The program administrator deems a qualified business that exceeds \$3,000,000 in annual sales no longer eligible as a qualified business for the subsequent year. A business may re-apply as a qualified business in the following year if its gross sales fall below \$3,000,000 and the business is fewer than 3 years old at the time of re-application.

APPENDIX IV. STATE PROGRAMS TO INCREASE ACCESS TO CAPITAL

| | Range of Capital Sources | | | | | | |
|------------------|-----------------------------|--------------------------------|-----------------------------|------------------------------|---------------------------|-----------------------------------|------------------------------|
| | Allocated State Funds | Dedicated State Revenues | Tax Credit Incentives | Credit- Enhanced Notes | State Pension Funds | Other State Fiduciary Funds | Private Lead Investors |
| Alabama | Y | - | - | - | - | Y | - |
| Alaska | - | - | - | - | - | Y | Y |
| Arizona | Y | - | - | - | - | - | - |
| Arkansas | Y | - | Y | - | Y | - | - |
| California | Y | - | - | - | Y | - | - |
| Colorado | - | - | - | - | Y | Y | Y |
| Connecticut | Y | - | - | - | Y | - | - |
| Delaware | Y | - | - | - | - | - | Y |
| Florida | - | - | - | - | Y | - | Y |
| Georgia | - | - | - | - | - | - | Y |
| Hawaii | Y | - | - | - | - | - | - |
| Idaho | - | - | - | - | - | - | - |
| Illinois | Y | - | - | Y | - | Y | - |
| Indiana | Y | - | - | - | - | - | Y |
| Iowa | Y | - | Y | - | Y | - | - |
| Kansas | Y | Y | Y | - | Y | - | - |
| Kentucky | - | - | Y | - | - | - | - |
| Louisiana | Y | - | Y | - | Y | - | - |
| Maine | Y | - | Y | Y | - | - | - |
| Maryland | Y | - | - | - | Y | - | - |
| Massachusetts | Y | - | - | - | Y | - | - |
| Michigan | - | Y | - | - | Y | - | - |
| Minnesota | Y | - | - | - | - | - | - |
| Mississippi | - | - | - | Y | - | - | - |
| Missouri | - | - | Y | - | Y | - | - |
| Montana | Y | - | Y | - | - | - | - |
| Nebraska | Y | - | - | - | - | Y | - |
| Nevada | - | - | - | - | - | - | Y |
| New Hampshire | Y | - | - | - | - | - | Y |
| New Jersey | Y | - | - | - | - | Y | - |
| New Mexico | - | - | - | - | - | Y | - |
| New York | Y | - | Y | - | Y | - | - |
| North Carolina | Y | - | Y | - | - | Y | Y |
| North Dakota | Y | - | - | - | - | - | - |
| Ohio | Y | - | Y | - | Y | - | - |
| Oklahoma | - | - | Y | Y | - | - | - |
| Oregon | - | Y | - | - | - | Y | - |
| Pennsylvania | Y | - | - | - | Y | Y | - |
| Rhode Island | - | - | - | - | Y | - | - |
| South Carolina | - | - | Y | - | - | - | - |
| South Dakota | - | - | Y | - | - | - | Y |
| Tennessee | - | - | - | - | - | - | - |
| Texas | Y | - | - | - | Y | - | - |
| Utah | Y | - | - | - | - | - | - |
| Vermont | - | - | Y | - | - | - | - |
| Virginia | Y | - | Y | - | - | - | - |
| Washington | - | - | - | - | - | - | - |
| West Virginia | Y | - | - | - | - | - | - |
| Wisconsin | - | - | Y | - | - | - | - |
| Wyoming | - | - | - | - | Y | - | - |
| Totals | 29 | 3 | 18 | 4 | 18 | 10 | 10 |

Source: Robert G. Heard and John Sibert, Ph.D., The National Governors' Ass'n, Growing New Businesses with Seed and Venture Capital: State Experiences and Options (2002) at 48 citing National Association of State Venture Funds. Updated to include Virginia and North Carolina

APPENDIX V. FIVE-YEAR PROJECTED PROGRAM PERFORMANCE

| | Calendar Year | | | | | Totals |
|--|---------------|---------------|---------------|---------------|---------------|---------------|
| | 2003 | 2004 | 2005 | 2006 | 2007 | |
| Annual amount of available tax credits | \$ 3,000,000 | \$ 4,000,000 | \$ 4,000,000 | \$ 4,000,000 | \$ 4,000,000 | \$ 19,000,000 |
| % of Qualified Investment eligible for tax credit | 25% | 25% | 25% | 25% | 25% | n/a |
| Corresponding amount of Qualified Investments ⁽¹⁾ | \$ 12,000,000 | \$ 16,000,000 | \$ 16,000,000 | \$ 16,000,000 | \$ 16,000,000 | \$ 76,000,000 |
| Taxpayer's max. Qualified Investment per year ⁽²⁾ | \$ 200,000 | \$ 200,000 | \$ 200,000 | \$ 200,000 | \$ 200,000 | n/a |
| Taxpayer's max. allowable credit per year ⁽³⁾ | \$ 50,000 | \$ 50,000 | \$ 50,000 | \$ 50,000 | \$ 50,000 | n/a |
| Minimum # of tax credit certificates issued ⁽²⁾ | 60 | 80 | 80 | 80 | 80 | 300 |
| Max. amount of investments QB may receive | \$ 600,000 | \$ 600,000 | \$ 600,000 | \$ 600,000 | \$ 600,000 | n/a |
| Minimum # of QBs receiving investment ⁽⁴⁾ | 20 | 27 | 27 | 27 | 27 | 100 |
| Minimum fees collected by Administrator: | | | | | | |
| Tax credit appl. fee (\$100 per taxpayer) ⁽²⁾ | \$ 6,000 | \$ 8,000 | \$ 8,000 | \$ 8,000 | \$ 8,000 | \$ 30,000 |
| Qualified Business appl. fee (\$200) ⁽⁴⁾ | \$ 8,000 | \$ 10,667 | \$ 10,667 | \$ 10,667 | \$ 10,667 | \$ 40,000 |
| Total administrative fees collected | \$ 14,000 | \$ 18,667 | \$ 18,667 | \$ 18,667 | \$ 18,667 | \$ 70,000 |
| Assumptions: | | | | | | |
| ⁽¹⁾ Taxpayers request maximum available tax credits each year; | | | | | | |
| ⁽²⁾ Each taxpayer makes the maximum qualified investment amount; | | | | | | |
| ⁽³⁾ Taxpayers have sufficient net tax liability to claim the maximum allowable credit; | | | | | | |
| ⁽⁴⁾ Minimum # of Qualified Businesses ("QB") receiving investments assumes that each QB receives three qualifying investments, each in the maximum amount of \$200,000. | | | | | | |