



Legislative Fiscal Bureau

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October 28, 2003

TO: Members
Joint Committee on Finance

FROM: Bob Lang, Director

SUBJECT: Senate Substitute Amendment LRB 0200/5 to Senate Bill 261: Individual and Corporate Income and Franchise Taxes: Income Tax Exclusion for Capital Gains from Certain Investments, Qualified Business Investment Tax Credit, and Related Administrative Responsibilities.

Senate Substitute Amendment LRB 0200/5 to Senate Bill 261 would provide an income tax exclusion for capital gains on certain investments and create income and franchise tax credits for investments in qualified businesses. SB 261 was introduced on September 24, 2003, and referred to the Joint Committee on Finance. However, the Co-chairs of the Committee have elected to take up Senate Substitute Amendment LRB 0200/5 to SB 261, which is addressed in this memorandum.

CURRENT LAW

There are several steps involved in calculating Wisconsin individual income tax liability. In brief, these steps are to: (a) determine Wisconsin adjusted gross income (AGI) by making additions and subtractions to federal adjusted gross income that are required under state law; (b) subtract the state's standard deduction and personal exemptions from AGI to find Wisconsin taxable income; (c) apply the state's tax rate and bracket schedule to taxable income to find the gross tax amount; (d) subtract applicable state tax credits from the gross tax amount to arrive at the net tax; and (e) determine if the state alternative minimum tax applies.

Current law provides a 60% individual income tax exclusion for capital gains from the sale of most assets held at least one year (long-term capital gains). In the case of certain business assets sold to family members and the sale of qualifying small business stock, long-term capital gains are completely excluded. There is no exclusion for short-term capital gains, which are the gains on sales of assets held for less than a year.

A corporation determines tax liability by: (a) computing gross income, including gains on the sale of capital assets; (b) subtracting allowable deductions; (c) apportioning and allocating income, if necessary; and (d) applying the tax rate of 7.9% to arrive at gross tax liability. To determine net tax liability, allowable credits are subtracted. Corporate income and franchise tax credits are provided for Wisconsin sales taxes paid on fuel and electricity used in manufacturing, qualified capital and noncapital research expenses, contributions to the Wisconsin Housing and Economic Development Authority, certain expenses to rehabilitate historical structures, and for certain economic activities in development, enterprise development, development opportunity, agricultural development, and technology zones.

SUMMARY OF SUBSTITUTE AMENDMENT

Senate Substitute Amendment LRB 0200/5 to Senate Bill 261 would provide: (a) an income tax exclusion for gains from the sale of investments in qualified businesses or venture capital funds; and (b) an income and franchise tax credit for investments in qualified businesses. The substitute amendment would also require the Department of Commerce to certify eligible businesses and venture capital funds and, in conjunction with the Department of Financial Institutions (DFI) and the Board of Regents of the University of Wisconsin, conduct related studies and surveys and provide educational and other support to investors.

Individual Income Tax Exclusion for Gains from the Sale of Investments in Certain Certified Businesses and Venture Capital Funds. The substitute amendment would provide a 100% individual income tax exclusion for long-term capital gains realized from the sale of an asset that is an investment in a certified qualified new business venture or a certified venture capital fund. Capital gains and capital losses would have to be netted in determining the exclusion.

Because current law allows 60% of all long-term capital gains to be excluded from taxable income, the net effect of the substitute amendment would to exclude from taxation 40% of a long-term capital gain on an investment in a certified qualified new business or certified venture capital fund.

Qualified New Business Venture Investment Tax Credit. The substitute amendment would provide a tax credit, under the individual and corporate income and franchise taxes, equal to 20% of the first \$100,000 of direct equity investments in a qualified new business venture, and 10% of amounts invested in such businesses that exceed \$100,000. Unused credit amounts could be carried forward up to 15 years to offset future tax liabilities.

If an equity investment is held by the claimant for less than one year, the claimant would be required to pay to the Department of Revenue (DOR), in a manner determined by the Department, the amount of credit received by the claimant that was related to the investment.

Partnerships, limited liability companies (LLCs), and tax-option corporations (S corporations) could not claim the credits, but eligibility for, and the amount of, the credit would be based on each entity's equity investment that was attributable to its business operations. A partnership, LLC, or tax-option corporation would be required to compute the amount of credit each of its partners, members, or shareholders could claim and provide that information to them. Partners, members of LLCs, and shareholders of tax-option corporations would claim the credit in proportion to their ownership interest.

The Department of Revenue would administer the tax credits, and current law provisions related to change of business or ownership and timely claims would apply to the qualified new business investment tax credit.

Qualified New Business Ventures. The substitute amendment would require that a qualified new business venture must be certified by the Department of Commerce. To be certified, the business would have to apply to Commerce for each tax year it wished to be certified. Commerce would be required to certify only the first 1,000 eligible businesses in the order in which their applications were received. In order to be certified, a business would have to satisfy all of the following conditions:

- (a) The business has its headquarters in the state.
- (b) At least 51% of the employees of the business are employed in Wisconsin.
- (c) The average annual net income of the business for each of the two tax years immediately preceding the tax year for which the credit is claimed is \$20 million or less.
- (d) The net worth of the business in the tax year for which the credit is claimed is \$40 million or less.
- (e) The business is not predominantly engaged in providing professional services by accountants, lawyers, or physicians.
- (f) The business is not engaged predominantly in wholesale or retail trade, or in the leisure and hospitality industry.
- (g) The business is not engaged in banking or lending, or in developing real estate for resale.
- (h) The business does not make loans to, or investments in, certified capital companies.
- (i) The business has been operating in Wisconsin for not more than 10 consecutive years.
- (j) The business is a corporation or limited liability company.

- (k) The business is not engaged in transportation or construction.

Certified Venture Capital Funds. Commerce would also be required to certify venture capital funds as eligible for investments that would qualify for the individual income tax capital gains exclusion in the substitute amendment. Commerce would have to promulgate administrative rules that permit the Department to certify a venture capital fund only if the fund: (a) is a private seed and venture capital partnership or entity fund; (b) has its principal place of business in Wisconsin; and (c) commits to maintain an average of 50% of its equity investments, calculated over a four-year period, in qualified businesses that are located in the state.

Department of Commerce Administration. Under provisions of the substitute amendment, the Department of Commerce would administer the certification process for qualified new business ventures and venture capital funds and would be required to promulgate administrative rules related to its administrative responsibilities. The substitute amendment specifies that, to be certified as a qualified new business venture, a business must submit an application to Commerce in each tax year for which it desires certification. Each year, Commerce would be required to certify only the first 1,000 eligible businesses in the order in which their applications were received. The Department would be required to notify DOR of every certified and decertified business and to maintain a list of certified businesses and permit public access to that list through the Department's Internet website. The rules would also have to require that, to be certified, the qualified new business venture must meet the criteria (related to net income, net worth, type of business, and age of business) described previously.

The substitute amendment also requires Commerce to promulgate rules establishing a procedure for certifying venture capital funds that include all of the following:

- (a) Require that, to be certified, the venture capital fund must file an application with the Department.
- (b) Permit the Department to certify a venture capital fund only if the fund is a private seed and venture capital partnership or entity fund, the fund has its principal place of business in Wisconsin, and the fund commits to maintain an average, calculated over a four-year period, of 50% of its equity investments in businesses that are located in Wisconsin.
- (c) Require an applicant for certification of a certified venture capital fund to provide Commerce with any information the Department determines is necessary to ensure eligibility for certification and compliance with the law and rules promulgated by the Department.

Upon the request of any person, the Department of Commerce would be required to issue a written notice indicating whether a venture capital fund is certified for the purpose of the capital gains exclusion. Each notice would have to include the following statement: "The Wisconsin Department of Commerce has not recommended or approved an investment in this venture capital fund or assessed the merits or risks of such an investment. Investors should rely solely on their own

investigation and analysis and seek investment, financial, legal, and tax advice before making their own decision regarding investment in this enterprise." When Commerce either certified or decertified an enterprise, it would have to notify the Department of Revenue and provide DOR with a copy of the certification or discontinuance. Commerce would also be required to submit proposed rules that are required under the substitute amendment to the Legislative Council staff for review by the first day of the sixth month beginning after publication of the substitute amendment.

Commerce, in cooperation with DFI and the Board of Regents of the University of Wisconsin System (UWS), would be required to conduct and publish an annual study of Wisconsin businesses to determine new business formation trends, identify obstacles faced by new Wisconsin businesses, and identify areas where changes in government policy may satisfy the needs of new Wisconsin businesses. As part of this study, Commerce would have to conduct a survey of Wisconsin businesses. Also, in cooperation with DFI and the Board of Regents of UWS, Commerce would be required to provide education and other support to facilitate the development of networks of investors that review new businesses or proposed new businesses for potential investment.

Effective Date. The substitute amendment would generally take effect on January 1, 2004. However, the individual and corporate income and franchise tax capital gains exclusion and tax credit provisions would first apply to tax years beginning on or after January 1, 2006. As noted, proposed rules would have to be submitted by the first day of the sixth month beginning after publication.

FISCAL EFFECT

Senate Substitute Amendment LRB 0200/5 to Senate Bill 261 would provide an income tax exclusion for gains from the sale of certain investments. A tax credit would be provided for investments in qualified new businesses. The Department of Commerce would be responsible for certifying businesses and venture capital funds. Commerce, the UWS, and DFI would be required to conduct and publish an annual study and provide support to investors.

The fiscal estimates for the proposed capital gains exclusion and tax credit provisions are based on the following sources of information: (a) Department of Revenue aggregate individual and corporate income and franchise tax statistics; (b) federal Internal Revenue Service (IRS) data; (c) federal Small Business Administration data; (d) Department of Financial Institutions data; (e) data from the national Venture Capital Association; and (f) interviews with numerous individuals active in various aspects of capital investment. However, due to the lack of specific data regarding aggregate investments of the type for which the exclusion and credit could be claimed and the assumptions made in developing the fiscal effect, the actual revenue effect of the substitute amendment's provisions could vary significantly from the estimated fiscal effect.

Individual Income Tax Exclusion for Capital Gains on Investments in Venture Capital Funds and Qualified New Business Ventures. The substitute amendment would provide a 100%

individual income tax exclusion for long-term capital gains from the sale of an investment in a certified qualified new business venture or certified venture capital fund. This treatment would first apply to tax years beginning on or after January 1, 2006. Consequently, there would be no fiscal effect during the 2003-05 biennium. However, once the provisions were effective in fiscal year 2006-07, it is estimated that annual individual income tax revenues would be reduced by \$100,000.

Investment Tax Credit. The substitute amendment would provide a tax credit, under the individual and corporate income and franchise taxes, equal to 20% of the first \$100,000 of direct equity investments in a qualified new business venture, and 10% of amounts invested that exceed \$100,000. Each year, only the first 1,000 businesses that were certified would qualify for the tax credit. Because the credit would first apply to tax years beginning on or after January 1, 2006, there would be no fiscal effect during the 2003-05 biennium. When the tax credit becomes effective in fiscal year 2006-07, it is estimated that annual income and franchise tax revenues would be reduced by \$8.0 million.

Administrative Provisions. Under provisions of the substitute amendment, the Department of Commerce would administer the certification process for qualified new business ventures and venture capital funds and would be required to promulgate administrative rules related to its administrative responsibilities. In addition, Commerce, in cooperation with DFI and the Board of Regents of the University of Wisconsin System, would be required to conduct and publish an annual study related to new business formation in Wisconsin. Also, in cooperation with DFI and the Board of Regents of UWS, Commerce would be required to provide support to certain investors.

The substitute amendment does not provide additional funding or positions for administration and related activities. However, in its fiscal note to SB 261 (which included similar provisions), Commerce indicates that SB 261 would add the following activities to the Department's workload: (a) certification of qualified new business ventures; (b) certification of qualified venture capital funds; (c) developing and publishing a study of Wisconsin businesses; and (d) providing education and support to investors. Commerce indicates that it would require 1.0 GPR position and \$64,600 GPR annually to perform these activities.

In its fiscal note to SB 261, the University of Wisconsin System indicates that the survey of state businesses and education and support activities would most likely be provided by the UW-Extension, Small Business Development Center or schools of business from the various UW campuses. The UWS indicates that, because the level of UWS involvement is not currently known, the fiscal effect the SB 261 provisions is indeterminate.

DFI indicates that it could provide support for the required activities with current staff.

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