



Legislative Fiscal Bureau

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September 30, 2003

TO: Members
Joint Committee on Finance

FROM: Bob Lang, Director

SUBJECT: Assembly Bill 524: Individual and Corporate Income and Franchise Taxes: Equity Investment and Venture Capital Fund Investment Tax Credits

Assembly Bill 524, which would create a state capital investment board and an equity investment and a venture capital fund investment credit, was introduced on September 18, 2003, and referred to the Assembly Committee on Economic Development. On September 29, 2003, that Committee adopted Assembly Amendment 1 by a vote of 8-0, and recommended Assembly Bill 524, as amended by AA 1, for passage by a vote of 8-0. The bill was referred to the Joint Committee on Finance on September 29.

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.

A corporation determines tax liability by: (a) computing gross income; (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 BILL

Assembly Bill 524 would create an equity investment and a venture capital fund investment credit, and the Wisconsin Capital Investment Board to assist in administering the tax credits.

Equity Investment Credit. AB 524 would create an individual income tax credit equal to 20% of the claimant's cash investment in a qualifying business or in a community-based seed capital fund. The maximum credit that could be claimed by an individual taxpayer would be \$50,000 in a tax year. The maximum total amount of credits that could be claimed by all taxpayers would be \$3.0 million in a state fiscal year. For individual claimants, unused credit amounts could be carried forward up to five years to offset future tax liabilities.

Single persons or married persons filing separate returns who were nonresidents or part-year residents would compute the credit by multiplying it by a fraction, the numerator of which was the individual's Wisconsin AGI and the denominator of which was the individual's federal AGI. Married couples filing joint returns, with one or both nonresidents or part-year residents, would compute the credit by multiplying it by a fraction, the numerator of which was the couple's joint Wisconsin AGI and the denominator of which was the couple's federal AGI.

The Department of Revenue would administer the credit and would be authorized to take any action or conduct any proceeding as under current income tax law. Income tax provisions relating to assessments, refunds, appeals, collection, interest and penalties would apply to the credit. Community-based seed capital funds and qualifying businesses would be required to submit to DOR any information the Department considered necessary to administer the credit.

Eligible claimants would be individuals who filed income tax returns. A community-based seed capital fund would be a fund certified by the Wisconsin Capital Investment Board. (the Board would be created under the bill). Under the bill, rules promulgated by the Board would be required to permit a community-based seed capital fund to be certified only if the fund was a partnership or limited liability company with a total of both capital commitments from investors and investments in qualified businesses of between \$500,000 and \$3.0 million. The fund would also be required to have at least 10 individual investors who were not affiliates. No investor and his or her affiliates could own more than 25% of the ownership interests outstanding in the fund.

A qualifying business would be a business certified by the Board. Rules promulgated by the Board would permit the Board to certify a business only if: (a) its principal business operations were in the state and had operated for three years or less; (b) the owner had at least three years of relevant experience, or had relevant training or education; (c) it was not engaged primarily in retail

sales, real estate, providing health care, or providing other professional services; and (d) it had a net worth of \$3.0 million or less.

Equity Investment in Venture Capital Fund Credit. AB 524 would also create, under the individual and corporate income and franchise taxes, a tax credit equal to 6.0% of the claimant's equity investment in a venture capital fund. The maximum credit that could be claimed by each taxpayer would be \$60,000. The maximum total amount credits that could be claimed by all taxpayers in a fiscal year would be \$5.0 million. Unused credit amounts could be carried forward up to 15 years to offset future tax liabilities. In order to claim the credit, a taxpayer would be required to submit, with the income or franchise tax return, a notice from the Wisconsin Capital Investment Board indicating that the venture capital fund was eligible to receive equity investments that qualify for the credit.

Partnerships, limited liability companies (LLCs), and tax-option corporations (S corporations) could not claim the credit, but eligibility for, and the amount of, the credit would be based on each entity's equity investment. 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 of their ownership interest.

The Department of Revenue (DOR) would administer the tax credit and current law provisions related to change of business or ownership and timely claims would apply to the venture capital fund investment credit.

Eligible claimants would include sole proprietors, partners, members of limited liability companies, shareholders of tax-option corporations, corporations, and insurance companies. An equity investment would be the purchase of an ownership interest.

A venture capital fund would have to be certified by the Board. Under rules promulgated by the Board, to be certified, the venture capital fund would have to: (a) be a private seed and venture capital partnership or entity fund; (b) maintain a physical presence in Wisconsin; and (c) make a commitment to consider making equity investments in businesses located in the state.

Department of Revenue Credit Allocation. DOR would be authorized to deny a portion of an equity investment or equity investment in venture capital fund credit, if granting the full amount of credit claimed would bring the total amount of credits claimed over the annual total maximum credit amounts of \$3.0 million and \$5.0 million, respectively.

Wisconsin Capital Investment Board. AB 524 would create a five-member Wisconsin Capital Investment Board attached to the Department of Commerce. Members of the Board would be appointed by the Governor, with the advice and consent of the Senate. Each member would be required to have expertise concerning venture capital and financial investments and would be appointed for five-year terms. Persons having a financial interest in a venture capital fund certified

by the Board could not be a member and any member who acquired such an interest would be required to withdraw from the Board.

The Board, in consultation with Commerce, would be required to promulgate rules establishing a procedure for the Board to certify venture capital funds as eligible to receive equity investments that would qualify for venture capital fund investment tax credits. Under the provisions of AB 524, these rules would have to:

(a) Require a venture capital fund to file an application with the Board in order to be certified.

(b) Permit the Board to certify a venture capital fund only if the fund (1) is a private seed and venture capital partnership or entity fund; (2) maintains a physical presence in Wisconsin; and (3) makes a commitment to consider making equity investments in businesses located in the state.

(c) Require an applicant for certification or a certified venture capital fund to provide the Board with any information the Board determines is necessary to ensure eligibility for certification and compliance with the law and rules promulgated by the Board.

The bill would also require the Board, in consultation with Commerce, to promulgate rules establishing a procedure for certifying community-based seed capital funds and qualified businesses as eligible to receive equity investments that would be eligible for the equity investment credit. The rules would have to do all of the following:

(a) Require a community-based seed capital fund to file an application with the Board in order to be certified.

(b) Permit a community-based seed capital fund to be certified only if the fund were a partnership or LLC with a total of both capital investments from investors and investments in qualified businesses of between \$500,000 and \$3.0 million.

(c) Permit a community-based seed capital fund to be certified only if the fund has at least 10 individual investors who are not affiliates with each other. No investor and his or her affiliates could own more than 25% of the ownership interests outstanding in the fund. "Affiliate" would be defined as a spouse, child, or sibling of an investor, or a corporation, partnership, LLC, tax-option corporation, or trust in which an investor has a controlling equity interest or in which an investor exercises management control.

(d) Require an applicant for certification or a certified community-based seed capital fund to provide the Board with any information the Board determines is necessary to ensure eligibility for certification and compliance with the law and rules promulgated by the Board.

The rules for certifying qualified businesses would have to do all of the following:

(a) Require a business to file an application for certification as a qualified business with the Board.

(b) Require a business to be in operation three years or less and have its principal business operations located in Wisconsin in order to be certified.

(c) Permit a business to be certified if the owner of the business: (1) has at least three years of relevant business experience, or any other experience that the Board determines is sufficient to increase the likelihood of the success of the business, or has successfully completed an entrepreneurial venture development curriculum; (2) has a degree in business management, business administration, or a related field; or (3) had any other training that the Board determined was sufficient to increase the likelihood of success of the qualified business.

(d) Not certify businesses that were primarily engaged in retail sales, real estate, providing health care, or providing other professional services.

(e) Require that the business must have a net worth of \$3.0 million or less to be certified.

(f) Require an applicant for certification or a certified community-based seed capital fund to provide the Board with any information the Board determines is necessary to ensure eligibility for certification and compliance with the law and rules promulgated by the Board.

Upon the request of any person, the Wisconsin Capital Investment Board would be required to issue a written notice indicating whether a venture capital fund, community-based seed capital fund, or business is certified. Each notice would have to include the following statement: "The Wisconsin Capital Investment Board has not recommended or approved an investment in this entity 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 entity." When the Board either certified or decertified an entity, it would have to notify the Department of Revenue and provide the Department with a copy of the certification or discontinuance. The Board would also be required to submit proposed rules that are required under AB 524 to the Legislative Council staff for review by the first day of the sixth month after the effective date of the bill.

The Board would be authorized to hire an unclassified executive director who could employ staff in the classified service who had the appropriate expertise to carry out the provisions of the bill. Under the bill, the Wisconsin Capital Investment Board would be provided 1.0 GPR executive director and 2.0 GPR positions that would be funded from the Department of Commerce's economic and community development general program operations appropriation. No additional funding would be provided for these positions.

Effective and Applicability Dates. The provisions of the AB 524 would take effect on the first day of the eight month beginning after publication, except that rule-making and position authority for the staff would be effective on the day after publication. The tax credit provisions would first apply to tax years beginning on January 1 of the year in which the bill took effect, except that if the bill took effect after July 31, the tax credit provisions would first apply to tax years beginning on January 1 of the year following the year in which the bill took effect.

ASSEMBLY AMENDMENT 1

Assembly Amendment 1 to AB 524 would modify provisions related to the Wisconsin Capital Investment Board to specify the method of selecting the five members. AA 1 would require one member to be appointed by the Speaker of the Assembly, one member to be appointed by the Majority Leader of the Senate, and the remaining three members to be appointed by the Governor, with the advise and consent of the Senate.

FISCAL EFFECT

Assembly Bill 524 would create an equity investment credit and equity investment in venture capital fund credit, and provide position authority for the Wisconsin Capital Investment Board under the Department of Commerce.

The fiscal estimates for the proposed tax credits are based on the following sources of information: (a) the MoneyTree Survey, which is a quarterly study of venture capital investment activity in the United States and is a collaboration between PricewaterhouseCoopers, Thomson Venture Economics, and the National Venture Capital Association; (b) separate data from the National Venture Capital Association; (c) federal Internal Revenue Service (IRS) data; (d) Department of Revenue aggregate individual and corporate income and franchise tax statistics; and (e) interviews with numerous individuals active in various aspects of capital investment.

Equity Investment Credit. AB 524 would provide an individual income tax credit equal to 20% of the claimant's cash investment in a qualifying business or a community-based seed capital fund. The maximum credit that an individual taxpayer could claim in a year would be \$50,000. The total amount of credits that could be claimed by all taxpayers in a fiscal year would be \$3.0 million. Using the information described above, it is estimated that the amount and number of investments that would be eligible for the credit would result in aggregate credit claims that would exceed the annual maximum limit of \$3.0 million. Consequently, the estimated annual fiscal effect of the credit would be to reduce state individual income tax revenues by \$3.0 million.

Equity Investment in Venture Capital Fund Credit. AB 524 would provide a tax credit, under the individual and corporate income and franchise taxes, equal to 6% of the claimant's equity investment in a venture capital fund up to a maximum credit of \$60,000 per year. The total amount

of credits that could be claimed by all taxpayers in a fiscal year would be \$5.0 million. Based on the information described above, it is also estimated that the amount and number of investments that would be claimed would result in total credits that would exceed the annual statewide maximum total of \$5.0 million. Therefore, the estimated fiscal effect of this credit would be an annual reduction of \$5.0 million in state individual and corporate income and franchise taxes.

Except for rule making and position authority, the provisions of AB 524 would take effect on the first day of the eight month beginning after publication. If that effective date was before July 31, the tax credit provisions would first apply to tax years beginning on January 1 of the year in which the bill takes effect. Otherwise the tax credit provisions would first apply to the following tax year. Consequently, if AB 524 is enacted before December 1, 2003, the tax credits would first apply to tax year 2004, and individual and corporate income and franchise taxes would be reduced by an estimated \$8.0 million in 2004-05. If the bill were enacted after December 1, 2003, the fiscal effect would first occur in 2005-06.

Position Authority. AB 524 would provide the Department of Commerce with 1.0 GPR unclassified executive director position and 2.0 GPR classified positions in 2003-04, under the Department's economic and community development general program operations appropriation. As noted, no additional funding for the positions would be provided.

Credit Allocation. Under the bill, DOR would be authorized to deny equity investment and venture capital fund investment tax credit claims if the total statewide amount of credits claimed exceeded the statewide maximum limits of \$3.0 million and \$5.0 million, respectively. The Department of Revenue indicates that it would incur significant administrative costs in applying the annual limits and processing and auditing returns filed for credits that exceeded the annual limits. The bill would not provide additional funding for DOR's expenses.

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