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Taxation of Capital Gains Reinvested in New Business Ventures (General Fund Taxes -- Income and Franchise Taxes)

[LFB 2009-11 Budget Summary: Page 254, #3]

CURRENT LAW

Under current law, an individual income tax exclusion is provided for 60% of the capital gain from the sale of assets held more than one year, although AB 75 would reduce the exclusion to 40%. An exception is extended for gains realized on the sale of business assets to a family member, which is described below. Gains from assets held one year or less are fully taxed. The amount of capital losses that may be used to offset ordinary income is limited to $500 annually, with the remainder carried over to future years. The state's top marginal income tax rate is 6.75% (7.75% under the bill). Therefore, with the 60% exclusion, long-term capital gains are generally taxed at a maximum rate of 2.7% (4.65% under the bill). The maximum effective tax rate is slightly higher for taxpayers who have income within the phase-out range for the sliding scale standard deduction.

A complete exclusion is provided for net long-term capital gains realized on the sale of business assets and assets used in farming to an eligible family member. An eligible family member includes a person who is related by blood, marriage, or adoption within the third degree of kinship, which includes children, grandchildren, great grandchildren, parents, grandparents, brothers, sisters, nephews, nieces, uncles, and aunts.

Besides individuals, this exclusion also applies to shares in a corporation or trust that meet the same standards that allow a corporation or trust to carry on farming operations in the state. These standards provide that the corporation or trust may not have more than 15 shareholders or beneficiaries (except that one family may count lineal ancestors and descendants, aunts, uncles, and first cousins as one shareholder), that there are no more than two classes of shares, and that all shareholders or beneficiaries are natural persons.

A family member who purchases a business under this provision is required to retain ownership for at least two years. If the business assets are resold within two years, a penalty will be imposed equal to the amount of income tax that would have been imposed on the initial seller if the complete exclusion did not apply to the transaction, prorated according to the amount of time the assets were held.

A special exclusion for long-term capital gains resulting from the sale of qualifying small business stock is also provided under state law. To be eligible, the stock must be purchased after December 31, 1985, and must be held for at least five years. In addition, the business must have the following characteristics: (a) at least 50% of its payroll and property is located in Wisconsin; (b) it employs no more than 500 employees covered by state unemployment insurance, including the employees of any corporation that owns more than 50% of the business' stock; (c) it receives no more than 25% of its gross receipts from rent, interest, dividends, and sales of assets combined unless the amount is under $3,000 and the corporation has been incorporated less than two years; (d) it has not previously issued stock listed on the major stock or securities exchanges; and (e) it has not liquidated or reorganized for the purpose of using this tax exemption.

Two limitations to this exclusion apply to stock acquired after August 15, 1991: (a) the exclusion is available only to the original purchaser of stock at the time the business is incorporated; and (b) an exchange of stock for stock does not qualify for the exclusion.

GOVERNOR

Authorize claimants to subtract from federal adjusted gross income any amount, up to $10 million, of a long-term capital gain if the claimant: (a) deposits the gain into a segregated account in a financial institution; (b) invests all of the proceeds in the account in a qualified new business venture within 180 days of the sale of the asset generating the gain; and (c) notifies the Department of Revenue (DOR) that the capital gain has been reinvested and, therefore, will not be declared on the claimant's income tax return. The notification would be made on a DOR form accompanying the claimant's income tax return for the year to which the claim relates. Specify that the basis for the investment in the new business venture would be calculated by subtracting the initial gain from the investment. Prohibit a claimant from using the initial gain to net capital gains and losses as otherwise allowed under current law. (State law limits the amount of capital losses that may be used to offset ordinary income to $500 annually, with the remainder carried over to future years.) Define "claimant" as an individual; an individual partner or member of a partnership, limited liability company (LLC), or limited liability partnership; or an individual shareholder of a tax-option corporation. Define "long-term capital gain" as the gain realized from the sale of any capital asset held more than one year that is treated as a long-term gain under the Internal Revenue Code (IRC).

Require the Department of Commerce to implement a program to certify qualified new business ventures, and authorize Commerce to certify businesses as such if they are engaged in: (a) developing a new product or business process; or (b) manufacturing, agriculture, or processing or assembling products and conducting research and development. Specify that a business desiring certification must submit an application to Commerce in each taxable year for which certification is desired. Prohibit Commerce from certifying businesses that are engaged in real estate development; insurance; banking; lending; lobbying; political consultation; professional services provided by attorneys, accountants, business consultants, physicians, or health care consultants; wholesale or retail sales; leisure; hospitality; transportation; or construction. Require Commerce to maintain a list of certified businesses, to permit public access to the lists through its Internet Web site, to notify DOR of every certification it issues, and to notify DOR of the dates on which certifications are revoked or expire.

The new tax deferral would first apply for tax years beginning after December 31, 2010, so no fiscal effect is estimated for the 2009-11 biennium. The administration estimates that the proposal would reduce individual income tax collections by approximately $14,000,000 annually in the 2011-13 biennium.

DISCUSSION POINTS

1. Private seed and venture capital helps fund new and small business enterprises that are unable to secure start-up funding through banks or the stock market. A 2008 Small Business Administration report entitled <u>The Small Business Economy</u> indicates that small businesses (fewer than 500 employees) accounted for 50.4% of the nation's employment in 2005 and that nearly 80% of the country's net new jobs come from small businesses.

2. A survey of state programs by the National Association of Seed and Venture Funds found that there are over 150 programs in 45 states dedicated to promoting or creating equity capital. Typically, the programs seek to promote certain state goals, such as job creation in targeted sectors, by encouraging early-stage business investments. The programs take a variety of forms including direct investments by states, state matching of investors and start-up companies, and state tax incentive programs. State tax credit programs provide incentives for individuals to invest in start-up businesses either with direct investments or through venture capital funds.

3. Currently, the state individual income tax extends several tax credits that are intended to encourage investment in new business ventures. DOR administers the credits jointly with the Department of Commerce. The angel investment credit is based on a claimant's investment in certain types of new business ventures certified by the Department of Commerce. Act 2 changed the credit's rate from 12.5% in each taxable year for two years to a rate of 25%. The early stage seed investment credit equals 25% of a claimant's investment paid to a certified fund manager that is then invested in certain types of new business ventures certified by the Department of Commerce. The investment must be held for at least three years. Neither credit is refundable, but unused credits from both programs may be carried forward. Also, both credits may be claimed against the alternative minimum tax.

4. Tax credit programs appear to be the most common type of state tax incentive for

encouraging start-up funding. In addition to Wisconsin's programs, tax credit incentives are offered in Alabama, Florida, Hawaii, Indiana, Louisiana, Maine, Missouri, New York, Ohio, Oklahoma, Texas, Vermont, and West Virginia, as well as, the District of Columbia and Puerto Rico. Capital gain deferrals are less common. Previously, Utah allowed a deduction for capital gains reinvested in Utah small businesses but recently changed the deduction to a nonrefundable tax credit. Colorado allows a deduction for capital gains income earned from stocks or ownership in a Colorado company, limited liability company, or partnership, provided the taxpayer owned the capital asset for at least five uninterrupted years prior to the sale.

5. Prior to 2009 Wisconsin Act 2, criteria for determining qualified new business ventures under the angel and early stage seed investment credits included developing a new product or business process, or manufacturing, agriculture, or processing or assembling products and conducting research and development. This is the same requirement that AB 75 would extend to qualified new business ventures eligible for reinvestment of capital gains. Act 2 repealed those criteria for the angel and early stage seed investment credits and replaced them with more detailed requirements based on the business' potential for increasing jobs, capital investment, or both, in Wisconsin.

6. While AB 75 would require qualified new business ventures to be engaged in certain types of activities, as enumerated above, the bill does not enumerate policy objectives for the capital gains reinvestment program. If the objective is to increase jobs or to increase investment in Wisconsin, the certification process could require the Department of Commerce to find that the business has "the potential for increasing jobs in this state, increasing capital investment in this state, or both," as is now required under the angel and early stage seed investment credits. This provision would also tie the business receiving the investment to Wisconsin. The bill does not impose this requirement. These changes to AB 75 are included in Alternative 2.

7. AB 75 would prohibit qualified new business ventures from engaging in real estate development; insurance; banking; lending; lobbying; political consultation; professional services provided by attorneys, accountants, business consultants, physicians, or health care consultants; wholesale or retail sales; leisure; hospitality; transportation; or construction. An identical prohibition under the angel and early seed investment credits was modified by Act 2 to extend only to business ventures that are "primarily" engaged in those activities. The AB 75 prohibition could be similarly modified (Alternative 3).

8. The proposed deferrals would first be allowed in tax years beginning after December 31, 2010. Delaying the proposal's effective date moves its initial fiscal impact outside the 2009-11 biennium, so no fiscal impact is reflected for the bill. However, DOR estimates that the proposal will reduce state income tax collections by $14.0 million annually beginning in 2011-12. Therefore, the proposal would represent an advanced commitment relative to the 2011-13 biennium.

9. A 2006 report entitled Seed and Venture Capital: State Experiences and Options by the National Association of Seed and Venture Funds indicated that institutional venture capitalists maintain a "typical investment horizon of $5 to $7 million per investment" and that the average

"deal size" for institutional venture capitalists in 2005 was $7.4 million. In addition, the report indicated that "seed and early stage capital needs for many (businesses) are in the range of $500,000 to $2 million." The bill's proposed annual deferral limit of $10 million per claimant is somewhat higher than these amounts. Reducing the limit to $5 million could lower the program's cost by an undetermined amount (Alternative 4). However, the cost reduction resulting from a lower limit is not likely to be significant because few taxpayers would be likely to be affected. In 2007, only 53 Wisconsin filers reported long-term capital gains greater than $5 million.

ALTERNATIVES

1. Approve the Governor's recommendation.

2. Modify the requirements for certifying a business as a qualified new business venture to include a finding by the Department of Commerce that the business has the potential for increasing jobs in Wisconsin, increasing capital investment in Wisconsin, or both.

3. Modify the provision prohibiting qualified new business ventures from engaging in certain activities by providing that the prohibition applies only to businesses that are "primarily" engaged in those activities.

4. Reduce the limit on the amount of deferred capital gains that may be reinvested in a qualified new business venture from $10 million to $5 million.

5. Delete provision.

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