

ECONOMIC DEVELOPMENT TAX INCENTIVE STUDY - ANGEL FUND INVESTMENT TAX CREDIT

Pursuant to North Dakota Century Code Section 54-35-26, created by 2015 Senate Bill No. 2057, a variety of economic development tax incentives are to be reviewed by a Legislative Management interim committee over the ensuing six-year period. The study is aimed at ensuring that economic development tax incentives are serving their intended purposes in a cost-effective and equitable manner. This memorandum has been provided to assist in the review of the angel fund investment tax credit and provides an explanation of the incentive, the perceived goals of the Legislative Assembly in creating or altering the incentive, and the data and testimony that will be required to conduct an effective analysis of the incentive.

EXPLANATION OF THE ANGEL FUND INVESTMENT TAX CREDIT

Section 57-38-01.26 provides for an angel fund investment tax credit. The incentive is available to all income taxpayers and allows for a credit against state income tax liability for investments made in an angel fund created under the laws of this state. A taxpayer may claim 45 percent of the amount remitted to each angel fund during the taxable year, up to an aggregate maximum amount of \$45,000 per year. The amount of the credit an individual, married couple, passthrough entity and its affiliates, or other taxpayer is allowed to claim is capped at a lifetime limit of \$500,000 in cumulative credits. An investment used to calculate an angel fund credit may not be used to calculate any other income tax deduction or credit.

A qualifying investment must be at risk in an angel fund for at least three years. An investment may be made from the assets of a retirement plan if the individual making the investment maintains a separate account and directly controls where the account assets are invested. An investment placed in escrow will not qualify for the credit. The credit must be claimed in the taxable year in which the investment is received by the angel fund. The amount of the credit claimed may not exceed the taxpayer's income tax liability. The amount of credit exceeding a taxpayer's liability may be carried forward to each of the seven succeeding taxable years. A taxpayer claiming this credit may not claim a credit resulting from an investment made by an angel fund in a qualified business for purposes of the seed capital or agricultural commodity processing facility investment tax credit.

Section 57-38-01.26 provides for the types of entities that may form an angel fund and provides that a fund must be organized for the purpose of investing in at least three primary sector companies that are early- and mid-stage private, nonpublicly traded enterprises with strong growth potential. An angel fund must consist of at least six accredited investors and may not have more than 25 percent of its capitalized investment assets owned by an individual investor. The angel fund must have at least \$500,000 in commitments from accredited investors which is subject to call to be invested over an unspecified number of years to build a portfolio of investments in enterprises. The angel fund must be member-managed or a manager-managed limited liability company and decisions regarding enterprises worthy of investment must be made on a group basis. The angel fund must be certified by the Department of Commerce and be in compliance with the security laws of this state.

Information must be filed by the angel fund with the Tax Commissioner within 30 days of the fund receiving an investment. This information includes the identifying information of the taxpayer or passthrough entity making the investment, the amount of the investment, and the date payment was received by the angel fund for the investment. The angel fund must also file a report with the Tax Commissioner within 30 days following the end of each year supplying the name and principal place of business of each enterprise in which the angel fund has an investment. The Tax Commissioner may disclose to Legislative Management the dollar amount remitted by each taxpayer or passthrough entity to an angel fund and the date each payment was received by the angel fund for the investment. The Tax Commissioner may also disclose to Legislative Management information provided by the angel fund pertaining to the principal place of business of each enterprise in which the angel fund has an investment.

An angel fund is restricted from investing in an enterprise if any one angel fund investor directly or indirectly owns more than 49 percent of the ownership interests in the enterprise. An angel fund also may not invest in an enterprise if any one partner, shareholder, or member of a passthrough entity directly or indirectly owns more than 49 percent of the ownership interests in the enterprise. Investors are prohibited from receiving more than \$5 million in aggregate credits from investments in a single angel fund during the life of the fund. A passthrough entity entitled to a credit must be considered the taxpayer for purposes of the credit and the amount of credit allowed must be determined at the passthrough entity level.

Section 57-38-01.26 also provides language regarding the sale, assignment, or transfer of the credit which was only available for investments made in the 2011 and 2012 tax years. Provisions are also included to allow the Tax Commissioner to adopt rules to administer the credit.

PERCEIVED GOALS OF THE LEGISLATIVE ASSEMBLY IN CREATING OR ALTERING THE ANGEL FUND INVESTMENT TAX CREDIT

Provisions regarding an angel fund investment tax credit first appeared in an early version of 2007 Senate Bill No. 2224, but language creating the credit was ultimately amended into and passed in 2007 House Bill No. 1018. Upon a review of the legislative history relating to both bills, the perceived goal of the Legislative Assembly in creating this credit was to encourage investment in start-up businesses by offering a tax credit to angel fund investors. The credit was described as an extension of the seed capital tax credit and was intended to stimulate private investment and grow start-up or early-stage companies in this state. Companies targeted by angel fund investments were thought to be smaller companies that carried high-risk but also high-growth potential. The angel fund investment tax credit was viewed as a tool to create and maintain quality jobs and diversify a community's economic base. The estimated fiscal effect of the angel fund investment credit could not be determined during the 2007 legislative session.

In 2009, the credit was amended through the passage of Senate Bill No. 2269 which served to tighten up the provisions of the credit. The bill imposed additional requirements necessary to qualify for the credit including the requirement that an angel fund be headquartered in this state, and invest in a portfolio of at least three early- or mid-stage private, nonpublicly traded enterprises. The bill required the fund to consist of at least six accredited investors, with no one investor owning more than 25 percent of the capitalized investment assets, and have at least \$500,000 in commitments from accredited investors. The bill also required the fund to be member-managed, certified by the Department of Commerce, and in compliance with state securities laws. The bill prohibited an angel fund from investing in an enterprise if one angel fund investor owned more than 49 percent of the enterprise. The bill also capped the aggregate amount of credits that could be received by investors in a single angel fund at a lifetime limit of \$5 million.

In 2011, House Bill No. 1057 further amended Section 57-38-01.26 by limiting the total lifetime amount of credits a taxpayer could obtain to \$150,000 per taxpayer. The bill also added passthrough entities to the list of investors eligible to receive the credit. Reporting requirements were also added and certain information contained within the required reports was allowed to be provided to the Legislative Management. The bill permitted an investor in an angel fund to sell or transfer up to \$100,000 of the investor's credits to another taxpayer, in the hopes of attracting more out-of-state capital to North Dakota and the carryover period for unused credits was increased from four to seven years. The bill also required the Tax Commissioner to report to the Legislative Management during the 2011-12 and 2013-14 interims on the number of in-state and out-of-state investors, the amount of each investment, and the amount of tax credits accrued, claimed, and transferred by each individual angel fund.

In 2013, Senate Bill Nos. 2325 and 2156 increased the lifetime credit limit from \$150,000 per taxpayer to \$500,000 per taxpayer. The bills also prohibited angel funds from investing in real estate or real estate holding companies. Any angel fund making these types of investments, and certified before January 1, 2013, would be barred from being recertified.

Information provided to the Political Subdivision Taxation Committee by the Tax Department on July 29, 2015, and later amended on August 12, 2015, indicates expanding use of the angel fund credit. The information shows the number of individual income tax returns on which the credit was claimed and the total amount claimed is as follows:

- In tax year 2007, a total of \$224,152 was claimed over 31 returns;
- In tax year 2008, a total of \$589,391 was claimed over 53 returns;
- In tax year 2009, a total of \$979,451 was claimed over 70 returns;
- In tax year 2010, a total of \$2,206,706 was claimed over 106 returns;
- In tax year 2011, a total of \$3,054,494 was claimed over 136 returns;
- In tax year 2012, a total of \$6,240,847 was claimed over 251 returns;
- In tax year 2013, a total of \$6,623,458 was claimed over 293 returns; and
- In tax year 2014, a total of \$4,552,176 was claimed over 247 returns.

The total amount claimed on corporate income tax returns in tax years 2006 through 2014 cannot be disclosed due to confidentiality restrictions as the credit was claimed on less than five returns in each tax year.

DATA AND TESTIMONY REQUIRED TO CONDUCT AN EFFECTIVE ANALYSIS OF THE ANGEL FUND INVESTMENT TAX CREDIT

Data pertaining to the following items will need to be collected to effectively analyze the incentive.

1. The number of claimants.
2. The fiscal impact of the incentive.
3. Employment opportunities, business growth, or diversity in the state's economy resulting from the availability of the incentive.
4. Negative impacts created as a result of the incentive.
5. Out-of-state impacts resulting from the incentive.

Testimony will need to be solicited from the following parties to effectively analyze the incentive.

1. The Department of Commerce.
2. The Tax Department.
3. The Economic Development Foundation.