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ECONOMIC DEVELOPMENT TAX INCENTIVE STUDY - ANGEL INVESTOR TAX CREDIT

Pursuant to North Dakota Century Code Section 54-35-26, created by Senate Bill No. 2057 (2015), a variety of economic development tax incentives are to be reviewed by a Legislative Management interim committee during each 6-year review period. The purpose of the review is to ensure economic development tax incentives are serving their intended purposes in a cost-effective and equitable manner. This memorandum is provided to assist in the review of the angel investor 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 INVESTOR TAX CREDIT

Section 57-38-01.26 provides for an angel investor tax credit for investments made after June 30, 2017. An angel investor is entitled to a credit against the investor's individual income tax liability for investments made by a certified angel fund into an in-state qualified business or an out-of-state qualified business. The credit is equal to 35 percent of the amount invested by the angel fund on behalf of the angel investor in an in-state qualified business and 25 percent of the amount invested by the angel fund on behalf of the angel investor in an out-of-state qualified business during the taxable year. The investment used to calculate the credit may not be used to calculate any other income tax deduction or credit and investments placed in escrow do not qualify for the credit.

The credit must be claimed in the taxable year in which the investment is made in the qualified business, and a taxpayer is limited to claiming no more than $45,000 in credits in any single taxable year and $500,000 in credits over any combination of taxable years. Angel investors may not receive more than $5 million in aggregate credits during the life of an angel fund. The credit allowed may not exceed the investor's tax liability and any excess may be carried forward to each of the 5 succeeding taxable years. A passthrough entity entitled to the 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.

To qualify as an out-of-state qualified business, a business must be organized as a for-profit entity and fall into one of two categories--an early-stage entity, with annual revenues of up to $2 million, or a mid-stage entity, with annual revenues over $2 million but not exceeding $10 million. An out-of-state qualified business must rely on research or the development of new products and processes in its plans for growth and profitability and comply with state and federal securities laws. However, an entity or enterprise that is engaged in real estate development, is a real estate holding company, derives income from the selling or leasing of residential or commercial real estate, or carries on operations in the hotel, restaurant, convention, or hospitality industries, or makes any other similar use of real estate is expressly excluded from qualification as an out-of-state qualified business for purposes of the credit.

In addition to meeting the criteria for an out-of-state qualified business, a business seeking certification as an in-state qualified business must be created as a for-profit entity, or have a satellite operation created as a for-profit entity, under North Dakota law and have its principal office in the state. An in-state qualified business also must have the majority of its business activity performed in this state, except sales activity, or have a significant operation in this state that has or is projected to have more than 10 employees in this state. Both in-state qualified businesses and out-of-state qualified businesses must be certified by the Department of Commerce.

An angel fund is defined under Section 57-38-01.26 and must:

- Be a passthrough entity organized after June 30, 2017, as a domestic for-profit entity under North Dakota law, and have its headquarters in the state.
- Not have invested, or intend on investing during its certification period, in certain real estate or real estate activities.
- Consist of at least six accredited investors as defined in Regulation D, Rule 501 of the federal Securities Act of 1933.
- Not have more than 25 percent of its capitalized investment assets owned by any one investor.
- Have at least $500,000 in commitments from accredited investors which are subject to call to be invested over an unspecified number of years to build a portfolio of investments in enterprises.
- Be a member- or manager-managed limited liability company and the investor members or a designated board that includes investor members must make decisions as a group on which enterprises are worthy of investments.
- Be certified as an angel fund by the Department of Commerce.
- Be in and remain in compliance with state and federal securities laws, and invest only in qualified businesses that are issuing securities in compliance with state and federal securities laws.

On or before December 31, 2019, and every 2 calendar years thereafter, a minimum of 50 percent of an angel fund's investments must be invested in an in-state qualified business. An angel fund is required to hold the investment in an in-state qualified business or an out-of-state qualified business for at least 3 years from the date of investment. The 3-year period does not apply if, before the end of the 3-year period, the investment becomes worthless; 80 percent or more of the assets of the qualified business are sold; the qualified business is sold; the common stock of the qualified business begins trading on a public exchange; or a partner, shareholder, or member of the angel fund dies, in which case the exception to the 3-year holding period only applies to the deceased individual's portion of the investment and related credit. An investment is defined as a cash investment in a qualified business which is made in exchange for common stock, a partnership or membership interest, preferred stock, debt with a mandatory conversion to equity, or an equivalent ownership interest as determined by the Tax Commissioner.

Angel investors may be actively involved in the qualified businesses in which the angel fund invests. However, the angel fund is prohibited from investing in any qualified business if any one angel investor owns directly or indirectly more than 49 percent of the ownership interests in the qualified business. This restriction also applies if the angel investor is a partner, shareholder, or member of another passthrough entity that directly or indirectly owns more than 49 percent of the ownership interests in the qualified business.

Within 30 days after the date on which an angel fund makes an investment in a qualified business, the angel fund is required to report the investment to the Tax Commissioner. The report includes information related to the identity of the angel fund, angel investors, and qualified businesses; investments from angel investors; and the type of security received by the angel fund in exchange for the investment. An angel fund is subject to a $1,000 penalty per month for each month the report is not filed. The Tax Commissioner, for good cause shown, may waive all or part of the penalty imposed. The angel fund is required to report additional information, including an annual report with investment details necessary for administration of the credit. Upon request by the Chairman of Legislative Management or chairman of a standing committee of the Legislative Assembly, the Tax Commissioner is required to disclose certain information received through reports submitted by angel funds.

Failure to comply with the requirements of the credit is cause to revoke the certification of an angel fund, an in-state qualified business, or an out-of-state qualified business, or to disallow the credit attributable to the noncompliance. Additionally, Section 57-38-01.26 imposes a penalty for submitting materially false or incomplete filings, as well as for failing to file required reports.

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

The angel investor tax credit was originally enacted as an angel fund investment tax credit. Provisions regarding the angel fund investment tax credit first appeared in an early version of Senate Bill No. 2224 (2007), but language creating the credit was ultimately amended into and passed in House Bill No. 1018 (2007). 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 and 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.

The credit was amended through the passage of Senate Bill No. 2269 (2009) 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 having 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.

House Bill No. 1057 (2011) 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 also were 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 4 to 7 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.

Senate Bill Nos. 2325 and 2156 (2013) 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.

House Bill No. 1045 (2017) eliminated the ability for investments made after June 30, 2017, to qualify for the angel fund investment tax credit and created a new angel investor tax credit applicable for investments made beginning July 1, 2017. The bill provided a credit against individual income tax liability for investments made by a certified angel fund in the amount of 35 percent of the amount invested in an in-state qualified business and 25 percent of the amount invested in an out-of-state qualified business. The bill required the credit be claimed in the taxable year in which the investment is made in the qualified business, and a taxpayer is limited to claiming no more than $45,000 in credits in any single taxable year and $500,000 in credits over any combination of taxable years. The bill also imposed various reporting requirements on angel funds, including a requirement to disclose the total amount invested in each qualified business, and attached penalties for failing to file the required reports.

A review of the legislative history relating to House Bill No. 1045 (2017) suggests the perceived goal of the Legislative Assembly in amending the provision to create a new angel investor tax credit was to address concerns associated with the prior version of the credit, specifically issues related to transparency, accountability, and the absence of sufficient restrictions on investments. The revised credit was designed to incentivize investment in small- to medium-sized businesses, particularly startups and businesses seeking venture capital to support expansion. The revisions to the credit sought to provide capital to businesses within the state which typically is not available through conventional financing due to elevated investment risk while maintaining appropriate safeguards to protect the state's investment in offering the credit.

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

To effectively analyze the incentive, the committee may wish to collect data pertaining to the following items:

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; and
5. Out-of-state impacts resulting from the incentive.

The committee also may wish to solicit testimony from:

1. The Department of Commerce;
2. The Tax Department; and
3. The Economic Development Association of North Dakota.