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## FISCAL IMPACT REPORT

ORIGINAL DATE 2/7/07

SPONSOR Robinson LAST UPDATED 2/8/07 HB \_\_\_\_\_

SHORT TITLE Angel Investment Credit For Businesses SB 864

ANALYST Francis

### REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Non-Rec	Fund Affected
FY07	FY08	FY09		
	(\$750.0)	(\$750.0)	Recurring	General Fund

(Parenthesis ( ) Indicate Revenue Decreases)

Duplicates HB 600

### SOURCES OF INFORMATION

LFC Files  
Securities and Exchange Commission

Responses Received From  
Taxation and Revenue Department (TRD)  
State Investment Council

### SUMMARY

#### Synopsis of Bill

Senate bill 864 creates a credit against personal income tax liability for qualified investments in New Mexico companies engaged in high technology research or manufacturing. The credit is only for qualified investors and is known as the angel investment credit. The maximum amount of the credit is \$25,000 per investment with a maximum of 3 investments per year per taxpayer. The credits must be certified by the economic development department which can only certify an aggregate of \$750,000 per year. Any portion of the credit that exceeds tax liability can be carried forward for three consecutive years.

The credit is allowed for tax year 2007 through tax year 2012 and is only good for investments through December 31, 2011. There is a provision that allows the carry forward past 2012 but no new credits.

**FISCAL IMPLICATIONS**

SB864 only allows the angel investment credit to accredited investors as defined by the Securities and Exchange Commission (SEC). SEC definition of “accredited investor” (for individuals):

- a natural person who has individual net worth, or joint net worth with the person’s spouse, that exceeds \$1 million at the time of the purchase;
- a natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year; (Rule 501-D Securities Act of 1933)

According to 2005 tax return data, there are approximately 22,000 taxpayers in NM with adjusted gross income greater than \$200,000 but according to the US Census, there are only 18 individuals in NM with a net worth greater than \$1 million in 2001. With the strong growth in the last five years, that number is estimated to be 25 individuals in 2007. Given this number of eligible investors, the \$750 thousand cap on the credit is highly likely to be reached each year. The fiscal impact recurs until FY2014 due to the delayed repeal provision and the three year carry forward.

**Table 1: Delayed repeal of angel investor credit**

Timeline	2007	2008	2009	2010	2011	2012	2013	2014	2015
Investments									
Credit									
Carry forward									

**SIGNIFICANT ISSUES**

SB864 defines a qualified business as one that has fewer than 100 employees, has not issued stocks publicly, and has less than \$5 million in gross revenues. The company must also be engaged in high technology research or manufacturing other than construction, farming, natural resource processing or meal preparation. The investor also cannot be affiliated with the company either through immediate family connection or business transactions within one year of the investment.

Representatives from the venture capital industry have indicated that anything to encourage investment in small areas is beneficial to New Mexico. In fact, angel investors are much more likely to invest in rural areas than are venture capitalists that have much stricter criteria for investments. Many venture capitalists will not consider an investment unless there is some level of investment locally, primarily an angel investor. Angel investors tend to know the business that they are investing in much more detail than venture capitalists. Also, angel investors have historically invested similar amounts as venture capitalists but in ten times the number of businesses, making this mode of investment much broader than what is typically the domain of venture capitalists.

It should be noted that the personal income tax rate cuts since 2003 have benefited these high income investors more than other New Mexicans. If you had \$200,000 in adjusted gross income, your New Mexico taxes decreased \$4,000 from 2003 to 2007. This is in addition to cuts at the federal level. This credit would allow high net worth taxpayers even more tax relief for investments they may already be inclined to make without additional incentive. Investments are also tax preferred income over other types of income. The federal government taxes capital gains, for example, at 15 percent rather than the top rate of 35 percent.

Investment in start-up or struggling companies is a risky investment which is why the tax credit is only meant to encourage those who have a higher risk tolerance than smaller investors. The returns, if there are any, are usually much greater than lower risk investments. Investors with high net worth tend to look for these investments without any tax incentives and it is unclear if a tax incentive even of this size will induce investments that would not otherwise be made. In other words, if it is a good investment, the investors will come but if it is a bad investment, no tax incentive will help.

**TRD:**

An angel investor is generally defined as an individual who provides capital to one or more startup companies. Angel investors are affluent and have a personal interest in the success of businesses in which they invest. Unlike partners, angel investors rarely manage firms they invest in. Angel investments are characterized by high levels of risk and potentially high returns on investment. Venture capitalists are also investors that provide capital for start-up or expansion and seek higher rates of return than would be given by more traditional investments. The primary difference between venture capitalists and angel investors is that venture capitalists are professional investors. Venture capitalists often have no business experience in the industries they invest in. Angel investors, on the other hand, often have business experience relevant to the companies they invest in and want to add value to the firms in addition to making a return on the investment.

According to the Angel Capital Association, angel investors provided approximately \$12.4 billion in financing to almost 28,000 entrepreneurial businesses in the first half of 2004, a substantial increase over the \$18.1 billion in all of 2003. A typical investor prefers to invest locally and enjoys a net worth in excess of \$1 million and an annual income of \$250,000.<sup>1</sup>

**State Investment Council:**

While the bill offers obvious tax benefits to New Mexico angel investors, the legislation primarily benefits the state's early and seed stage high tech companies. This sizeable and growing entrepreneurial community currently has somewhat limited funding options when developing new ideas or technology into a marketable product or company. Start-up companies, which by definition lack a track record for their technology or service, rarely have the ability to attract private equity funds or similar investors like the State Investment Council. On the other end of the spectrum, start ups also often have difficulty securing significant lines of credit or funding from standard banking entities, as their product/technology/company is still in development or prototype stage, where profit does not yet exist.

The SIC believes this legislation would help fill an existing lending/funding "gap" in New

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<sup>1</sup> [http://www.gmtoday.com/news/local\\_stories/2004/December\\_04/12152004\\_06.asp](http://www.gmtoday.com/news/local_stories/2004/December_04/12152004_06.asp)

Mexico by giving investors additional incentive to invest in young companies and early stage technology. While these types of investments are high risk, they are also high reward, and can have lasting and significant impact in creating jobs and growing NM's economy.

## **ADMINISTRATIVE IMPLICATIONS**

### **TRD:**

Provisions of the proposal would probably require a new claim form to be developed and a new line on the PIT-ADJ form. The proposal would also require changes to other forms, instructions and publications. Manual review would be necessary to track credit applications and carry forwards. Moreover, it would be difficult for the Department to determine whether claims for the credits are consistent with the various conditions pertaining to the types of businesses which would qualify for the investments and that the investors qualify within the meaning of Rule 501 of the Federal Securities Act.

## **CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP**

House Bill 600 is a duplicate bill.

## **TECHNICAL ISSUES**

### **TRD:**

The proposal does not identify procedures by which a taxpayer can claim the credit. The proposal does not make clear, for example, whether taxpayers must apply for the credit and whether the Department, prior to a taxpayer's taking the credit on their personal income tax return, must approve the claim for credit.

The term "principal place of business" is not defined in the bill. The terms would be important in determining which business investments are eligible for the credit.

The term "qualified investor" should be changed to "accredited investor" on page 2, line 18 of the proposal.

## **OTHER SUBSTANTIVE ISSUES**

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<sup>2</sup> [http://www.gmtoday.com/news/local\\_stories/2004/December\\_04/12152004\\_06.asp](http://www.gmtoday.com/news/local_stories/2004/December_04/12152004_06.asp)