# FISCAL IMPACT REPORT

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|---|---|---|---|---|---|
| | | **ORIGINAL DATE** | 01/27/14 | | |
| **SPONSOR** | Griego | **LAST UPDATED** | 02/07/14 | **HB** | |
| **SHORT TITLE** | Angel Investment Tax Credit Changes | | | **SB** | 114/aSCORC |
| | | | | **ANALYST** | Graeser |

## REVENUE (dollars in thousands)

| Estimated Revenue Impact* | | | | | Recurring or Nonrecurring | Fund(s) Affected |
|---|---|---|---|---|---|---|
| **FY2014** | **FY2015** | **FY2016** | **FY2017** | **FY2018** | | |
| $0.0 | ($450.0) | ($850.0) | ($1,250.0) | ($2,000.0) | Recurring | General Fund |

(Parenthesis ( ) Indicate Revenue Decreases)

The current sunset for investments is December 31, 2016. Thus, the FY 15, 16, and 17 impacts are against a base of $350.0. The base for the FY 18 estimate, however, would be $0, since it is after the current sunset date, which is extended to December 31, 2024 per SCORC amendment.

Note: see discussion in “Other Substantive Issues” of the transfer to the Federal Treasury from the State. State taxes are deductible from federal AGI, hence lower State personal income taxes because of this credit are accompanied by higher Federal taxes. The Angel Investment Credit is only applicable to non-Sub C corporate taxpayers, which includes individuals and pass-through entities including investment partnerships.

## ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

| | FY14 | FY15 | FY16 | 3 Year Total Cost | Recurring or Nonrecurring | Fund Affected |
|---|---|---|---|---|---|---|
| **Total** | | | | | Recurring | General Fund |

(Parenthesis ( ) Indicate Expenditure Decreases)

Neither EDD nor TRD estimate that additional staff would be needed to process claims made pursuant to this bill.

**SOURCES OF INFORMATION**
LFC Files

Responses Received From
Economic Development Department (EDD)
Department of Finance and Administration (DFA)

**SUMMARY**

Synopsis of SCORC Amendment

Senate Corporations and Transportation Committee’s amendment reinstates a sunset date for the Angel Investment Credit and cancels the credit for investments made after December 31, 2024.

Synopsis of Original Bill

Senate Bill 114 increases the annual amount of Angel Investment Credits that can be issued to an aggregate $2 million and eliminates some restrictions on the type and number of investments that can be made and still be eligible for the Angel Investment Credits. The credit percentage remains at 25 percent, but the amount of a qualified investment increases to $250,000 from $100,000. Rather than claiming the Angel Investment Credit for up to two qualified investments in a tax year, the bill allows only one qualified investment per investment round (federal definition) and in no more than five qualified businesses per taxable year.

The former restriction that the total credit amount for investments made by a partnership or business association was limited to $25,000 is repealed. The total allowed credit in the business limit is replaced by focusing on the investor, and not the partnership or business association. However, each member of a partnership or business association may only claim a credit on the individual's pro-rata ownership interest in the partnership. The bill also eliminates the December 31, 2016 sunset date on the credit. The credit remains non-refundable, but the carry-forward period is extended to five years from the current three. The definition in current statute of "high technology research" is replaced by the federal definition of "qualified research" as defined in Section 41 of the Internal Revenue Code. A majority of employment and a majority of the investment must be located in New Mexico. Claims will be paid by TRD on a first-come, first-served basis. If the total claims in a year exceed the $2 million cap, the unpaid claims will be granted priority for the following fiscal year.

**FISCAL IMPLICATIONS**

Utilization of the Angel Investment Credit for the two most recent years has increased significantly. The history, as reported by DFA is as follows:

| Year | No. of Investments | Amount | |
|---|---|---|---|
| 2005 | 2 | $130 thousand | |
| 2006 | 2 | $330 thousand | |
| 2007 | 6 | $785 thousand | |
| 2008 | 7 | $1.31 million | |
| 2009 | 6 | $750 thousand | |
| 2010 | 5 | $562 thousand | |
| 2011 | 2 | $1.3 million | |
| 2012 | 7 | $1.6 million | |
| **Total** | **37** | **$6.8 million** | (averaging $183,000 per investment) |

Note that this table is consistent with the data reported in the FIR for 2012's HB-123, if each investment generated about 6 claims. In that bill, with similar provisions, the budget year fiscal impact estimate was ($150.0) and the out-year estimate ($270.0). In that bill review, TRD reported data for the Angel Investment Tax Credit claims for fiscal years 2008 to 2011, with an increase the number of claims from 40 in FY2011 to 65 in FY2013 and 80 in FY2014 expected. About 32 claims for an average $204 thousand were claimed in each of these four fiscal years. However, there were 44 claims for $248,682 in year FY11. Approximately $6,100/25%=$24,400 was invested in New Mexico for each claim per year; hence total qualified investments would be $895 thousand per year. These data are approximately consistent with the data reported in TRD's

2012 Tax Expenditures report.

TRD reports:

> "…currently, the angel investment tax credit amounts to an average of about $350 thousand per year. This bill expands the opportunity for investors to make more investments per year and also raises the credit to twenty-five percent of $250 thousand per investment. Using confidential taxpayer data from previous years of the angel investment tax credit and making estimates of the level of new investment attracted by the increased maximums, the Taxation and Revenue Department (TRD) estimates that the credit will increase gradually until reaching the new yearly maximum of $2 million in fiscal year 2018. Due to the amount of time needed for planning large investments, a portion of the initial increase is projected to come from existing investors. TRD data shows that in a given year there are a few investors that are already making qualified investments greater than $100 thousand, even though they will only receive a credit on the first $100 thousand under the current statute. Those investors would receive a larger credit on the same size investment under this bill, and would have the opportunity to make more eligible investments in a year. Over time, it is expected that the increased credit amounts available will attract new investors which should push the credit to reach the new cap."

**SIGNIFICANT ISSUES**

In order for an activity to qualify for an Angel Investment Credit, the research must meet all the requirements as described in section 41(d) of the Internal Revenue Code. Under section 41(d), the term "qualified research" means research:

1. With respect to which expenditures may be treated as expenses under section 174, (also known as the section 174 test);
2. Which is undertaken for the purpose of discovering information which is technological in nature, (also known as the discovering technological information test);
3. The application of which is intended to be useful in the development of a new or improved business component of the taxpayer (also known as the business component test); and
4. Substantially all of the activities of which constitutes elements of a process of experimentation for a qualified purpose (also known as the process of experimentation test).

To be considered "qualified research", the taxpayer must be able to establish that the research activity being performed meets ALL four of the above tests. These tests must be applied separately to each business component of the taxpayer.

DFA comments, "… the definition of 'qualified research' under Section 41 of the Internal Revenue Code is nearly identical to that under current law with the exception that the IRC excludes the following: research after commercial production, adaptation of existing business components, duplication of existing business components, surveys, studies, etc., computer software, foreign research, social sciences, etc., and funded research."

DFA also comments on the policy, "… this bill will allow angel investors to make additional investments in New Mexico small businesses, which could foster entrepreneurship in the state, especially as loan requirements and credit have tightened following the collapse of the housing bubble. Local angel investors have noted that the largest limitation under current law is the number of investments allowed per tax year. Under House Bill 94, angels will be allowed an unlimited number of investments provided they invest in no more than 5 different businesses and only make one investment per investment round. Increasing the cap on aggregate credits will allow greater investment in New Mexico small businesses while limiting the impact to General Fund revenues."

New Mexico Angels typically provide funding to 3 or 4 out of an average of 300 investment opportunities a year after five rounds of review, screening, presentation and selection.

Under current federal guidelines, an accredited investor must have individual or joint net worth with a spouse that exceeds $1 million. However, the federal government is considering relaxing this requirement to allow investors of more modest means to buy small equity stakes of private companies. This could potentially increase the pool of eligible investors in New Mexico and could provide greater benefit of the tax credit.

**EFFECTIVE DATE**

Not stated -- May 21, 2014; applicable for taxable years beginning on or after January 1, 2014. Per SCORC amendment, the provisions o0f the bill sunset for investments made after December 31, 2024.

**PERFORMANCE IMPLICATIONS**

The LFC tax policy of accountability is met with the bill's requirement (7-2-18.17 (F) NMSA 1978) to report annually to an interim legislative committee regarding the data compiled from the reports from taxpayers taking the credit and other information to determine whether the Angel Investment Credit is meeting its purpose.

**ADMINISTRATIVE IMPLICATIONS**

EDD is responsible for certifying angel investments for the purpose of the Angel Investment Credit claims. This could become a burden if the number of claims exceeds 100.

**DUPLICATION**

Duplicates HB 94

**TECHNICAL ISSUES**

EDD comments, "'Completed Applications' is not defined. Staff recommends that 'Completed Application' be defined as follows:

> 'Completed Application' means an application that the Economic Development Department has determined includes all required supporting documentation and a notarized claimant's affidavit and which has met all statutory requirements required to be issued a certificate."

**OTHER SUBSTANTIVE ISSUES**

According to New Mexico Angels, 318,480 angels pumped $22.5 billion into 66,230 U.S. companies (according to figures from the University of New Hampshire's Center for Venture Research) with an average deal size of $339 thousand in 2011. This compared to venture capital funding for these early-stage companies of $9.21 billion, according to the National Venture Capital Association (NVCA). 1-in-10 start-ups obtains angel financing with an average funding size of $350 thousand, and 1-in-30 angel deals see venture capital financing with an average funding size of $2.5 million.

**OTHER SUBSTANTIVE ISSUES**

Does the bill meet the Legislative Finance Committee tax policy principles?

1. **Adequacy**: Revenue should be adequate to fund needed government services.
2. **Efficiency**: Tax base should be as broad as possible and avoid excess reliance on one tax.
3. **Equity**: Different taxpayers should be treated fairly.
4. **Simplicity**: Collection should be simple and easily understood.
5. **Accountability**: Preferences should be easy to monitor and evaluate

While this expansion of the Angel Investment Credit can be considered a current tax expenditure and does impose a cost on the General Fund of up to $2 million per year, one major success, or several moderate successes from each year's class of investments could repay the General Fund loss many times over. EDD notes that the investments considered by Angel Investors are seed money and startup investments, not subsequent round investments that are of interest to venture capitalists. These are high risk investments.

This is unlikely to become a tax shelter for very wealthy individuals. In fact, a state tax credit such as this actually transfers taxes from the State to the Federal treasury, since lower net State taxes result in lower amounts of itemized deductions on the federal 1040, hence greater taxes at the Federal level. Most qualified investors will recognize that the effective credit amount after taxes is not 25 percent but approximately 70 percent of the State tax credit amount, or about 17 percent.

**WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL**

If this bill is not passed, the Angel Investment Credit will sunset for investments made after December 31, 2016. For 2011, the total credit claims implied investment of about $900 thousand, representing perhaps 10 jobs at a cost of $25 thousand per job created. This would be amortized in increased taxes paid by the employees in about 10 to 12 years. However, if the Angel Investment Credit is responsible for a few companies that emerge from small business status to become major employers in the state, the investment will pay dividends far greater than the costs.

EDD comments: "… not enacting this bill will limit the availability of start-up companies to raise capital in New Mexico, thereby stifling growth and innovation. Angel Investors assume high risk and these types of incentives can help provide some relief, allowing for more investments in start-up businesses.

**POSSIBLE QUESTIONS**

With this increase in the amount and number of investments per year, is it likely that the $2,000,000 limit in total claims be reached soon? If so, should there be another sunset date imposed so that the credit can be thoroughly reviewed and data presented to establish the total revenue increase and jobs created through this mechanism.

Have any of the companies that have received Angel Investment support emerged from startup status to become major employers in the State?

LG/jl:ds