# FISCAL IMPACT REPORT

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|---|---|---|---|---|---|
| | | **ORIGINAL DATE** | 02/6/15 | | |
| **SPONSOR** | Sanchez, C | **LAST UPDATED** | 03/17/15 | **HB** | |
| **SHORT TITLE** | Angel Investment Minimum and Sunset | | | **SB** | 413 |
| | | | | **ANALYST** | Graeser |

## REVENUE (dollars in thousands)

| **Estimated Revenue Impact*** | | | | | **Recurring or Nonrecurring** | **Fund(s) Affected** |
|---|---|---|---|---|---|---|
| **FY2015** | **FY2016** | **FY2017** | **FY2018** | **FY2019** | | |
| $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 in this bill to 2025.

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 taxpayers subject to the provisions of the Income Tax Act. This includes Sub S corporate taxpayers, individuals and other pass-through entities including investment partnerships.

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

| | **FY15** | **FY16** | **FY17** | **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. TRD reports a small cost for forms.

**SOURCES OF INFORMATION**
LFC Files
Taxation and Revenue Department’s 2014 Tax Expenditure Report

Responses Received From
Economic Development Department (EDD) (2014 HB-94)
Department of Finance and Administration (DFA)
Taxation and Revenue Department (TRD)

## SUMMARY

Synopsis of Bill

Senate Bill 413 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 thousand from $100 thousand. Rather than claiming the angel investment credit for up to two qualified investments in a tax year, the bill allows each investor only one qualified investment per investment round (federal definition) and investments 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 thousand is simply repealed. The limit for total allowed credits in the single business 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 extends the December 31, 2016 sunset date on the credit to December 31, 2015. 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

TRD estimates the fiscal impact of this bill as follows:

> "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 2019. 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."

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

| Calendar Year | No. of Investments | Amount of CY Investment | Amt. of Credit | Avg. Investment | Avg. Per Investment |
|---|---|---|---|---|---|
| 2005 | 2 | $130 | $33 | $65 | $17 |
| 2006 | 2 | $330 | $83 | $165 | $42 |
| 2007 | 6 | $785 | $196 | $131 | $33 |
| 2008 | 7 | $1,310 | $328 | $187 | $47 |
| 2009 | 6 | $750 | $188 | $125 | $31 |
| 2010 | 5 | $562 | $141 | $112 | $28 |
| 2011 | 2 | $1,300 | $325 | $650 | $163 |
| 2012 | 7 | $1,600 | $400 | $229 | $57 |
| 2013 | 6 | $1,500 | $375 | $250 | $63 |
| Total | 43 | $8,267 | $2,067 | $192 | $48 |

The amount for Calendar Year 2013 has been approximated and the amount for Calendar Year 2014 not reported. The average investment from the inauguration of the credit during the 2007 through FY 2013 has averaged $192,000 per investment and $48,000 in credit amounts per investment. Note: data for CY 2013 and 2014 have not been provided at the time of this review.

TRD has just published the 2014 Update of the Tax Expenditure report. In that document, TRD reports claims paid as follows:

| | FY 2009 | FY 2010 | FY 2011 | FY 2012 | FY 2013 |
|---|---|---|---|---|---|
| Fiscal Impact | $152.80 | 261.6 | 250 | 325.2 | 310.7 |
| Number of Claims Paid | 27 | 37 | 44 | 60 | 45 |

These tables do not seem consistent, but they are reporting different things. The DFA table is based on information from the Angel Investors and the TRD data is based on claims actually paid. Notice that there may be as many as 9 claims (individuals) per investment.

**SIGNIFICANT ISSUES**

TRD notes the purpose of this credit: “The increases to the angel investment tax credit are intended to create an environment that is conducive to the creation and growth of research and manufacturing small businesses.”

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: assume 90 days after adjournment or June 19, 2105.Applicable for taxable years beginning on or after January 1, 2015.

## 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-261

## TECHNICAL ISSUES

EDD comments on last year's HB-94 and SB-114, "'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."

DFA recommends that on page 1, line 25 and page 2 line 1 the stricken language "not more than" be restored. Angel investors are allowed a 25 percent credit against the amount of their investment; the amount of the investment that is eligible is capped at $250 thousand. DFA also recommends a definition specific to the bill of "full-time employment".

## 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

While this expansion of the Angel Investment Credit is 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**

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

LG/bb/je