



STATE OF CALIFORNIA
Franchise Tax Board

Analysis of Original Bill

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| Author: Burke | Sponsor: | Bill Number: AB 2758 |
| Analyst: Raj Lawrence | Phone: (916) 845-7774 | Introduced: February 16, 2018 |
| Attorney: Bruce Langston | Related Bills: See Legislative History | |

Subject: Angel Investor Investments in Qualified Small Businesses Credit

Summary

This bill would, under the Personal Income Tax Law (PITL) and the Corporation Tax Law (CTL), allow a tax credit to a taxpayer for investing in certain small businesses.

Recommendation – No position.

Reason for the Bill

The reason for this bill is to incentivize investment in small businesses by providing a tax credit.

Effective/Operative Date

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2020, and before January 1, 2030.

Federal/State Law

Existing federal and state laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses or to influence behavior, including business practices and decisions. These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

There are currently no federal or state credits comparable to the credit this bill would create.

This Bill

For each taxable year beginning on or after January 1, 2020, and before January 1, 2030, this bill would, under the PITL and CTL, allow a credit in an amount equal to 5 percent of the amount paid or incurred by an angel investor for investing in a qualified small business for the taxable year in which the Franchise Tax Board (FTB) issues a credit certificate.

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This bill would define the following terms:

- “Angel investor” means:
 - an accredited investor who comes within any of the following categories described under applicable Securities and Exchange Commission Regulations, as of the effective date of this act,
 - who seeks returns through private investments in start-up companies, and
 - may seek active involvement in the business, including consulting and mentoring the entrepreneur.

Angel investor would specifically exclude a person who serves as an executive, officer, employee, vendor, or independent contractor of the business in which an otherwise qualified cash investment is made.

- “Permitted entity investor” means:
 - Any general partnership, limited partnership, (sic)corporation that has in effect a valid election to be taxed as an “S” corporation under the Internal Revenue Code (IRC), or a limited liability company that has elected to be taxed as a partnership under the IRC, and
 - Was established and is operated for the sole purpose of making investments in other entities.
- “Qualified small business” means a business that has:
 - \$2,000,000 or less in gross receipts annually averaged over five years, and
 - 51 percent or more of the business is owned by individuals who are members of a group that been underrepresented in securing investor dollars.

To receive a credit, the angel investor would be required to:

- Apply to the FTB for a credit, and
- Apply for a credit certificate from the FTB, after the angel investor has invested in a qualified small business.

The FTB would be required to:

- Provide, upon application, a reservation for the credit to an angel investor, if the aggregate amount of the credit allocation amount for the year has not been reached.
- Grant a certificate to an angel investor upon receiving evidence that money has been invested in a qualified small business that meets the definition of qualified small business.

The annual aggregate amount of credits that may be allocated each fiscal year would be \$15,000,000.

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Credits in excess of the tax liability may be carried over for up to five years.

The bill specifies that the credit would be excluded from the requirements of the Revenue and Taxation Code section 41. The credit would be repealed by its own terms as of December 1, 2030.

Implementation Considerations

Department staff have identified the following implementation considerations for purposes of a high-level discussion; additional concerns may be identified as the bill moves through the legislative process. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

It is unclear whether the credit for a taxable year would be five percent of the amount paid or incurred during the taxable year, or 5 percent of the amount paid or incurred over the ten year period from January 1, 2020, to January 1, 2030. For clarity and consistency with the author's intent, this bill should be amended.

The bill would define a term "Permitted Entity Investor," that is otherwise unused in the bill. For clarity and consistency with the author's intent, the bill should be amended.

This bill uses the undefined term, "group that has been underrepresented in securing investor dollars." The absence of a definition clarifying this term could lead to disputes with taxpayers and would complicate the administration of this bill. For clarity and ease of administration, it is recommended that the bill be amended.

It is unclear whether "gross receipts" for purposes of determining eligibility as a qualified small business refers to gross receipts reportable to California or all gross receipts.

The bill lacks administrative details necessary to administer the credit. For example,

- How would requests for credit reservations be processed for purposes of managing the allocation limit? First come first serve?
- What "information and evidence" would an angel investor be required to provide to receive a credit certificate from the FTB?
- Would a request for credit reservation that exceeds the allocation limit be allowed up to the remaining allocation amount or disallowed entirely?
- How would a credit claimed without a credit reservation, certificate, or both, be handled?
- Would an under allocated credit amount from one fiscal year be available for allocation in the subsequent year?
- How would the FTB determine that the definition of angel investor had been met? Would the determination need to be made on an annual basis?
- When and how often would the determination be made as to whether a business was a qualified small business for purposes of this credit? At the time of the initial investment? Initial credit reservation request? Annually during the period of investment?

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Because the bill fails to specify otherwise, a business in existence for less than five years would fail to meet the definition of qualified small business for the purpose of this credit. If this is contrary to the author's intent, this bill should be amended.

The credit would be allowed for tax years beginning on or after January 1, 2020, and before January 1, 2030, which is inconsistent with the language what would allow the credit to be based on amounts paid on January 1, 2030, a date in a tax year the credit is no longer available. For internal harmony and consistency with the author's intent, this bill should be amended.

Because the bill fails to specify otherwise, an angel investor that withdrew their investment upon receiving the credit certificate would remain eligible for the credit.

The bill lacks recapture provisions.

This credit would require the FTB to reserve and certify the credit this bill would allow. Typically, credits involving areas for which the department lacks expertise are certified by another agency or agencies that possess the relevant expertise. The certification language would specify the responsibilities of both the certifying agency and the taxpayer. It is recommended that this bill be amended to include a certifying agency.

Legislative History

AB 999 (Burke, 2017/2018) would have created a tax credit for certain taxpayers that invest in qualified small businesses. AB 999 failed to pass out of the Assembly by the constitutional deadline.

Other States' Information

The states surveyed include *Florida*, *Illinois*, *Massachusetts*, *Michigan*, *Minnesota*, and *New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida and *Michigan* laws lack an angel investor program.

The *Illinois* angel investment program offers tax credits to businesses and individuals who make an investment in one of *Illinois*' qualified new business ventures principally engaged in innovation. These businesses must have been in operation less than 10 years, have less than 100 employees at time of certification for the program, and have at least 51 percent of the employees employed in *Illinois*. They must not have received more than \$10,000,000 in cash or \$4,000,000 in investment under this program. The amount of the credit is equal to 25 percent of the investment made directly into a qualified new business venture. The minimum investment requirement is \$10,000 in any single business. The maximum amount of an applicant's total investment made directly in any single qualified business venture that may be used as a basis for the credit is \$2,000,000. The maximum aggregate amount of the angel investment credit is \$20,000,000.

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The *Massachusetts* angel investment program allows a credit equal to 20 percent, or 30 percent in some cases, of the amount invested in a business with 20 or fewer employees, with a fully developed business plan, with at least 50 percent of its employees in the principal place of business, and gross income of \$500,000 or less in the previous fiscal year. The maximum a taxpayer may claim in a single calendar year is \$50,000.

Minnesota law currently lacks a credit similar to the credit this bill would allow. However, for tax years 2010 through tax year 2017, a credit was provided to encourage investment in small business start-ups in certain industries in *Minnesota*. The credit was equal to 25 percent of any new investment in a qualified business, up to \$125,000 for individuals, \$250,000 for couples filing jointly. The credit limit was \$15 million for tax years 2014 through 2016, and \$10 million for tax year 2017; half of these credits are reserved for minority- or women-owned qualifying businesses, or businesses in greater *Minnesota*.

Fiscal Impact

The department's costs to implement this bill have yet to be determined. As the bill moves through the legislative process, costs will be identified.

Economic Impact

Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of AB 2758 as Introduced February 16, 2018
For Taxable Years Beginning On or After January 1, 2020
Assumed Enactment after June 30, 2018

(\$ in Millions)

| Fiscal Year | Revenue |
|-------------|----------|
| 2018-2019 | \$0 |
| 2019-2020 | - \$7.7 |
| 2020-2021 | - \$14.0 |

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill or for the net final payment method of accrual.

Revenue Discussion

Research indicates that angel investors invest over \$7 billion dollars in California businesses annually. For the credit to be fully allocated \$300 million of this \$7 billion dollars, or approximately 4 percent, would need to be invested in qualified small businesses. This estimate assumes the credit would be fully allocated and the FTB would make \$15 million in credit reservations each year over the life of the credit. Federal regulations require angel

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investors have annual income greater than \$200,000 or net worth greater than \$1 million (excluding the value of their personal residence); therefore, taxpayers receiving the credit would be likely to have a tax liability sufficient to offset the credit. It is assumed that 90 percent of the credit would be used in the year generated and the remaining 10 percent would be used in the following 5 years. This results in a net revenue loss of approximately \$14 million in the 2020 taxable year.

The tax-year estimates are split between personal income taxpayers and corporate taxpayers, converted to fiscal-year estimates, and then rounded to arrive at the amounts reflected in the above table.

Support/Opposition

Support: None provided.

Opposition: None provided.

Arguments

Proponents: Some may argue that this bill could encourage investment in small business that sometime struggle in this economy.

Opponents: Some may argue that there are already incentives available for investors that choose to invest in small businesses.

Policy Concerns

This bill would allow a credit for investments that may be deductible as business expenses. Generally, a credit is allowed in lieu of a deduction in order to eliminate multiple tax benefits for the same item of expense.

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