To Compete,

Indiana Must be Aggressive

Adjustment to Venture Capital Tax Credit Program Could Lead to Big Results: Transferable Tax Credits

Many states have recognized and are tracking the beneficial impact of angel investors and venture capitalists and are adopting and improving legislation to promote such investments.

Increased investment into new ventures drives business innovation with the associated investment tax credits becoming a vital way to facilitate the availability of capital. VC tax credits are a valuable tool to encourage entrepreneurial growth and small business development.

Allowing the transfer or sale of VC tax credits within a contractually controlled environment and with oversight from the Indiana Economic Development Corporation (IEDC) will improve the usefulness of Indiana's Venture Capital Tax Credit program.

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Introduction

Entrepreneurs think differently, strive for greatness, and face risk straight on. They are determined and unyielding in their drive to build successful companies. However, the expedition from entrepreneur to CEO is full of tests and trials. To succeed, an entrepreneurial company needs a leader, team, vision, plan and especially access to cash especially in the critical startup period.

VC companies and individual or group angel investors provide early-stage financing to entrepreneurs. These investors typically invest in companies that are viewed as too risky by banks. They assist with growth by filling the gap in funding required beyond investments by family, friends and company founders.

Under current Indiana law, VC tax credits can only be used if the tax credit recipient has a corresponding state income tax liability. If a tax credit recipient has no income tax liability, the tax credits essentially have no value. However, states like Wisconsin and Iowa have monetized certain tax credits, by making them transferable, essentially reaching for out-of-state investment.

State Competitiveness

Indiana is listed as the 6th Best State for Business 2014 by CEO Magazine. The magazine's ranking is based on state and local tax and regulatory regime, workforce quality, quality of life and cost of living factors, education and health. In 2010, Indiana was ranked 16th. By trimming several taxes and enacting Right to Work legislation Indiana advanced 10 places. Other states with big gains were Louisiana (from 40 to 31) Wisconsin (from 41 to 27), Ohio (from 43 to 16) and North Dakota (from 24 to 12). All of these states have reduced the burden of government, have reasonable property tax rates and low income tax rates. They also have strong secondary and higher education systems and are creating formal and informal networks and opportunities for entrepreneurial activities. Worst ranked states were Massachusetts at 46, followed by New Jersey, Illinois, New York, and California again, according to CEO Magazine's rating.

Still, the Wall Street Journal's third annual ranking (The Next Big Thing, 2013) of the top 50 venture-capital-backed companies shows that 37 out of 50 ranked are based in California where the largest share of venture capital is invested, while four are in New York and three are in Massachusetts. Indiana did not have any companies on the list.

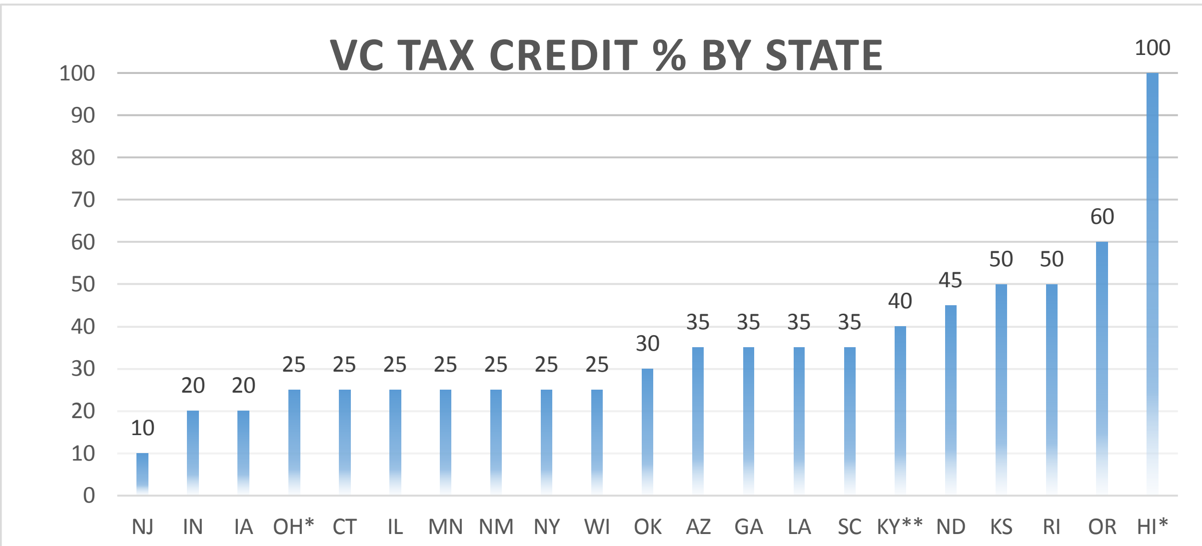
The east and west coasts are leading regions for investment and innovation in part from the positive factors that make them great places to live and work. They sustain excellent research institutions, a highly educated workforce and a culture of risk-taking. This kind of atmosphere draws entrepreneurs and investors alike despite the substantially higher costs of living and doing business.

Transferable tax credits are a way to help Indiana companies compete with the coasts for capital by providing the financial encouragement angel investors or VC companies need to consider Indiana-based ventures.

In Indiana, investors who provide qualified debt or equity capital to eligible companies currently receive a 20% credit against their Indiana tax liability. There is a $1,000,000 tax credit cap. As an example, an investor who invests $100,000 into an Indiana-based company can take the tax credit ($100,000 X .20 = $20,000 credit) against personal state income taxes. If the credit exceeds the liability then the credit carries forward for up to five years. This carry forward feature is common in many states for tax credits that are not transferable or refundable.

About half of all states offer venture capital tax credits in some form. The percentage of the credit, tax types that may be offset and eligible activities vary from state to state. At least five states, (KS, KY, LA, SC, and WI) allow transferable VC and/or other tax credits. Transferable tax credits allow out-of state investors with no state tax liability to sell these credits on the market to individuals or companies that have a state tax liability. The market price is determined by risk and the time value of money; however there are various rules and regulations that must be complied with when selling the credits and each state does it just a bit differently. That's a topic for the next article!

The following graph shows allowed VC Tax Credit percentage by several states. This is not meant to be an exhaustive list and note that there are many and varied rules and regulations to be followed.



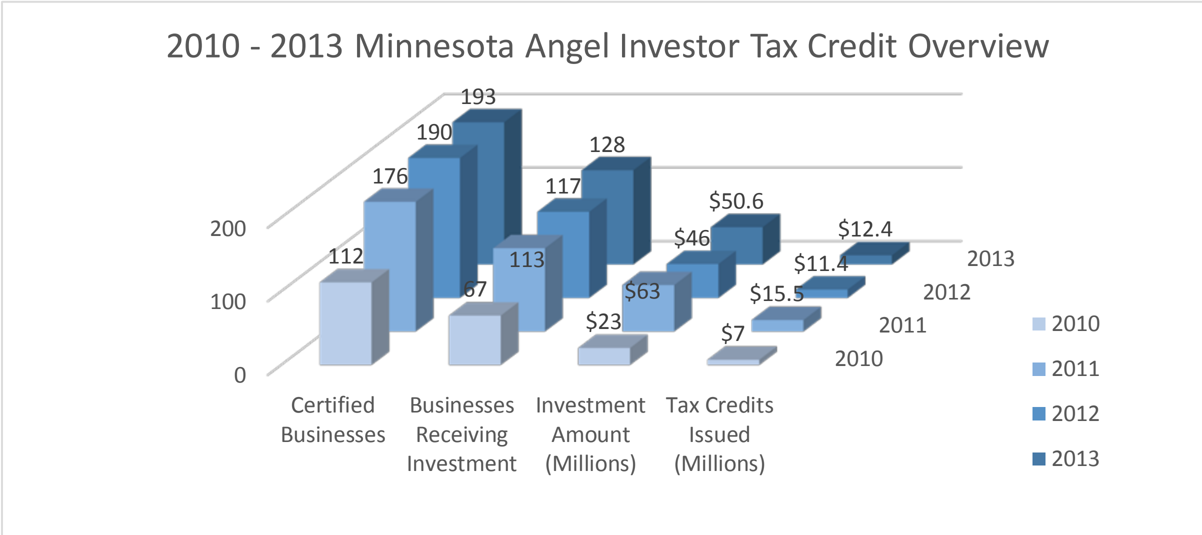
*Please note that OH & HI tax credit programs are suspended. **KY tax credit program to begin in 2015

Wisconsin: Transferable Tax Credit

In 2005 Wisconsin made tax credits available for residents of the state who invest in start-up companies based in the state. Since the program took effect, the number of angel-investor groups in the state has grown from four to over 25.

Wisconsin also shows the value of angel tax credits in job creation. The 2012 Qualified New Business Venture Annual Report created by the Wisconsin Economic Development Corporation calculated that 1,102 full-time jobs had been created by 160 companies that had received investments prompted by the state's tax credits. That may not seem like many jobs, however, we have to weigh quality more than quantity. The average annual salary for those 1,102 jobs was $76,581, creating a total associated payroll of $84.4 million. High-income jobs are especially helpful to the economy because they produce greater tax revenue than lower-paying jobs. Those companies will create many more jobs as they continue to grow.

In April 2014, Wisconsin made the venture capital tax credit transferable in order to stimulate further investment and to better compete with neighbor Minnesota who has a refundable angel/VC tax credit.



Minnesota: Refundable Tax Credit

The Minnesota state legislature adopted a 25% tax credit for individual investors launched in July 2010. Minnesota goes a step further by offering refundable tax credits instead of transferable credits meaning that if the tax credit exceeds the liability it reverts back to the tax payer as a cash refund.

The program was created to stimulate private investment in emerging businesses and to encourage job creation through the growth of those businesses. Substantial investment was made in Minnesota's businesses by non-Minnesotans. In 2013, non-Minnesotan investors accounted for 29% of overall investment, an increase from 28% in 2012, 27% in 2011, and 22% in 2010, according to the Minnesota Angel Tax Credit Program 2013 Annual Report.

Kentucky 2015 Program Kick-off

On January 1, 2015, Kentucky will launch an aggressive angel investment tax credit program. Kentucky has made growing and supporting start-ups a key part of its economic development strategy. Highlights of Kentucky's new program include that investors can claim a 40% investment tax credit that expands to 50% if the company is located in a high unemployment area. Out-of-state individuals who invest in Kentucky startups can sell their tax credits to Kentucky residents. This positions Kentucky well to strongly compete with its neighbors.

Example: A California investor who has a $5,000 Kentucky tax credit sells it to a Kentucky resident for $4,000. The California investor gets cash, and the Kentucky resident reduces his or her tax bill and profits $1,000 on the deal.

"We had to give these folks access to capital to purchase materials, hire new employees, and build out the rest of their products," said Adam Caswell, vice president for public affairs at the Northern Kentucky Chamber of Commerce. "The angel tax credit was Priority One."

www.Cincinnati.com / Josh Pichler / 4/24/2014.

Summary

Good investors certainly base their decisions on the quality of a company not a tax credit, but the credit offers an additional incentive for investors who are interested in a startup but do not live in-state.

Proponents argue tax credits make a positive difference by leaving angels with more money to invest and by encouraging people who have never invested in a start-up to try it. Critics say there is not enough evidence that credits increase investment levels or create enough jobs to justify the hit to governments' tax revenues.

States benefit because growing companies create jobs ultimately improving the state and local economy. Indiana would be better positioned to attract investment to innovative Hoosier companies by increasing the percentage allowed for the tax credit and making the credit transferable.

There <u>is</u> evidence that tax credits are bringing new investors, creating quality jobs and building vibrant business communities.