

# Statement of Estimated State Revenue Impact

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**Date:** April 9, 2013

**Bill Number:** H.B. 3505

**Authors:** Loftis, Bannister, Harrell, J.R. Smith, Brannon, *et. al.*

**Committee Requesting Impact:** House Ways & Means Committee

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## Bill Summary

A bill to amend the Code of Laws of South Carolina, 1976, by adding Chapter 44 to Title 11 so as to enact the "High Growth Small Business Access to Capital Act of 2013" by providing for state nonrefundable income tax credits for qualified investments in businesses meeting certain criteria and primarily engaged in manufacturing, processing, warehousing, wholesaling, software development, information technology services, research and development or other nonprohibited services, to establish the criteria and procedures for the credit, to make the credit transferable, and to provide for certain adjusted net capital gain and loss computations for investor taxpayers who recognize such a gain or loss on the sale of credit assets as defined in this chapter.

## REVENUE IMPACT <sup>1/</sup>

This bill is expected to reduce General Fund individual income tax revenue by an estimated \$6,000,000 in FY2013-14, and reduce General Fund individual income tax revenue by an estimated \$8,000,000 each fiscal year thereafter for ten years after the repeal date of this legislation on July 1, 2019.

## Explanation

This bill would add Chapter 44 to Title 11 to create the "High Growth Small Business Access to Capital Act of 2013". Similar tax credit incentive programs have been implemented in 25 states, including North Carolina and Georgia. This bill would allow an angel investor to claim a nonrefundable state income tax credit of thirty-five percent of its qualified investment in a business start-up company. If a qualified investment is made in a South Carolina Launch portfolio business, the nonrefundable tax credit is increased to fifty percent. SC Launch is a private, not-for-profit South Carolina Research Authority (SCRA) affiliate. It is collaboration among SCRA and South Carolina's university research foundations – Clemson University, the Medical University of South Carolina and the University of South Carolina. It supports the creation of early-stage, knowledge-based companies in obtaining funding to commercialize their products and create high wage jobs. Total tax credits may not exceed \$8,000,000 for all taxpayers in any one taxable year, and total tax credits may not exceed \$100,000 for an individual taxpayer in a single taxable year. A taxpayer may apply fifty percent of the allowed tax credit to the investor net tax liability during the tax year the qualified investment is made, and the remaining fifty percent of the tax credit may be applied to any net taxable liability in future tax years. Any unused tax credits may be carried forward for ten years and tax credits may not be used against prior years' tax liability. Tax credits are transferrable by the heirs and legatees of the qualified investor upon death and/or to his spouse. The tax credit may be transferred only once to any taxpayer, but may be carried forward for ten years from the

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original date of issue.

An angel investor is an accredited investor who is a resident of this state or a nonresident who is obligated to pay taxes in this state, or is a pass-through entity which is formed for investment purposes, has no business operations, and does not have committed capital exceeding \$10,000,000. A pass-through entity means a partnership, an S-corporation, or a limited liability company taxed as a partnership. The individual investor or the pass-through business may invest in a qualified business that meets the following criteria – is either a corporation, limited liability company, or a general or limited partnership located in this state; was organized no more than five years before the qualified investment was made; is headquartered in this state; employs 25 or fewer people; has had gross annual revenue of \$3,000,000 or less in any complete fiscal year before registration with the Secretary of State; and is primarily engaged in specific types of businesses such as manufacturing, processing, warehousing, wholesaling, software development, information technology services, and research and development.

Angel investors are different from venture capitalists. Angel investors generally invest their own money in business start-ups and very early stage companies, while venture capitalists mostly provide capital they have raised from others to later-stage businesses for growth. A venture capital fund or commodity fund with institutional investors or a hedge fund does not qualify as a “qualified investor”. An angel investor is an individual who invests directly into promising entrepreneurial businesses in return for stock in the companies or a share of the profits. To be an accredited investor pursuant to the Securities Act of 1933 requires a net worth of \$1,000,000 or an annual income over \$200,000. Under the Securities Act of 1933, a company that offers or sells its securities must register the securities with the Securities and Exchange Commission or find an exemption from the registration requirements. The most widely used exemptions are rules 505 and 506 of Regulation D which allows a company to sell its securities to “accredited investors”. An angel group is individual angel investors that join together with other angel investors to evaluate and invest in entrepreneurial ventures. They pool their capital to make larger investments. According to the Angel Capital Association, there are 300 member angel investor groups in the United States. There are two angel investor groups in South Carolina. They are the Charleston Angel Partners (CHAP) and the Upstate Carolina Angel Network (UCAN) in Greenville.

A qualified angel investor seeking to claim a tax credit must submit an application to the Department of Revenue to seek tentative approval of the tax credit. The Department would notify each qualified angel investor of the tax credits that are approved and allocated to the investor by January 31<sup>st</sup> for the year after the application was submitted. If the total amount of tax credits applied for exceeds the maximum amount of tax credits allowed, the tax credits must be allocated among the qualified investors on a pro rata basis.

According to the Angel Capital Association, a professional alliance of angel groups in North America, there were 8,000 accredited angel investors that financed business start-ups investing an average of nearly \$307,500 per project in 2011. After adjusting these figures to


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comparable state figures, we estimate that 120 investors in South Carolina would qualify as angel investors. Multiplying 120 accredited angel investors by an annual tax credit limitation of \$100,000 per individual investor for all projects yields an estimated \$12,000,000 that may be applied for by investors with the Department of Revenue in a tax year. Because fifty percent of the allowed tax credit may be used in the tax year the qualified investment is first made, an estimated total of \$6,000,000 of tax credits could be claimed in the first tax year of the program. We expect that the maximum limitation of \$8,000,000 set aside for accredited angel investors would be met in future tax years. This bill is expected to reduce General Fund individual income tax revenue by an estimated \$6,000,000 in FY2013-14, and reduce General Fund individual income tax revenue by an estimated \$8,000,000 each fiscal year thereafter.

This bill would also add Section 11-44-65 to allow the qualified taxpayer to apply the tax credit against any net capital gain realized from the sale of credit assets by the taxpayer. A "credit asset" is a capital asset acquired by the taxpayer who is eligible to claim the income tax credit. This section would tax any realized net capital gain income by the taxpayer/investor by treating the net capital gain as ordinary income up to an amount of tax equal to the amount of the state credit. This income would be taxed at the rate of seven percent instead of at the tax rate of 3.92 percent for capital gain income. This would mitigate the risk to the state by recouping some of the loss of subsidizing the investment in high-risk, high growth start-up companies. All of the capital gain realized in excess of the credit amount would then be taxed at the preferential capital gains tax rate of 3.92 percent. Conversely, if an angel investment results in a failed outcome, the investor would only be able to deduct the portion of loss over and above the credit limitation of 35 percent on their state income tax return. As a result, the net capital loss may be fully deductible on an angel investor's federal income tax return, but the net capital loss would not be fully deductible on the angel investor's state income tax return. This would prevent the occurrence of "double dipping" – the ability to fully apply a tax provision at the federal level as well as at the state level.

Lastly, each year, the Secretary of State would report to the House Ways & Means Committee and Senate Finance Committee all of the businesses that have registered with the Secretary of State as qualified businesses. This act takes effect upon approval by the Governor, and the tax credits are first available for tax years after December 31, 2012. The provisions contained in this act are repealed on July 1, 2019.



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Frank A. Rainwater  
Chief Economist

**Analyst:** Martin

<sup>11</sup> This statement meets the requirement of Section 2-7-71 for a state revenue impact by the BEA, or Section 2-7-76 for a local revenue impact of Section 6-1-85(B) for an estimate of the shift in local property tax incidence by the Office of Economic Research.