Community Development
Venture Capital Alliance
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# STATE TAX CREDIT INCENTIVES FOR EQUITY INVESTMENTS:

# A SURVEY OF CURRENT PRACTICES

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## I. INTRODUCTION

Venture capitalists have helped create vibrant entrepreneurial economies in cities and regions such as such as Silicon Valley, Route 128 in Massachusetts, Austin and San Diego. In recent years, a few states without this established equity investor base and seeking community economic development have adopted tax incentives for direct investment into local businesses and/or into seed capital funds.

Eighteen states have adopted such tax credit programs, the majority of which offer investors tax credits ranging from 20 to 40% of the amount invested directly into a business or seed capital fund. These incentive programs are meant to offer investors additional incentive to invest in businesses and regions and/or industries that policymakers believe need additional equity capital, and to cushion, but not eliminate, the risk of loss. States adopt such tax credit programs for many reasons, ranging from diversifying their economic base to creating new businesses and jobs. Some states have specifically targeted equity investment in rural and/or low-income areas. New York, Maine and Oklahoma are examples. States implement such programs expecting the cost of these credits to be offset by increases in corporate and personal income taxes and the many benefits of increased employment.

In January, 2004, the Community Development Venture Capital Alliance ("CDVCA"), the trade association for the community development venture capital fund industry, began working with students from Harvard University's Kennedy School of Government to survey existing state tax credit incentives for equity investment directly into businesses and/or seed capital funds. This abridged article, written by the students with input and information provided by CDVCA, has been adapted from this study and a longer research paper conducted and written by the students. The purpose of the research was to understand the attributes of different state programs and their implementation strategies, with the hope of identifying key trends and insights useful to influencing future community development tax credit programs and policy. Since then, we have learned that a much larger and longer-term initiative to study the impact of different state tax incentives on economic development, The State Capital Formation Project, is expected to begin later this year, being led by the Milken Institute and others.

Survey results reveal:

1. Tax credit programs for direct investment into a business or into a seed capital fund are found in 18 states, mainly in the Midwest and Mississippi Valley. Most of these states are below the median in terms of GDP per capita and have attracted little or no venture capital from traditional sources.
2. The policy window for tax credit programs appears to be open, as many states have passed programs in the last five years.
3. Tax credits can be structured in a number of ways to meet state objectives. Some of the tools policymakers can use include: percent of credits per investments; geographic and industry restrictions.

4. Despite outreach efforts, some programs have experienced shortfalls between their allocated and actual tax credit disbursements.
5. Not all states are tracking program effectiveness. This not only limits a state's ability to improve programs mid-way but also makes programs vulnerable to changing political environments.

In addition, though not the focus of the study, the survey revealed that at least seven states have committed to issue guarantees in the form of tax credits to investors in state-sponsored fund of funds programs. Investors are promised a guaranteed return, and if the state-sponsored fund is not able to make loan payments from its profits, the investor can utilize tax credits to make up the difference. The fund of funds invests the proceeds into venture funds that commit either to invest or to consider investing in that state. The seven states that the survey identified have authorized the issuance in aggregate of over $600 million in contingent tax credits.

## II. FINDINGS

In our analysis of state tax credit programs, we placed these programs into three main categories, described below:

**Direct Tax Credit**: Tax credit for an institutional or individual investor for an equity investment directly into a qualified business.

**Seed Capital Credit**: Tax credit for an institutional or individual investor for an investment into a qualified investment fund making equity investments.

**Contingent Tax Credit**: Tax credit given to investors only in the event that a state-sponsored fund of funds is unable to fulfill the financial returns contractually defined by its investors.

Appendices A through C provide descriptions of each of these types of programs by state.

### 1. *Tax credit programs for direct investment into a business or into a seed capital fund are found in 18 states, mainly in the Midwest and Mississippi Valley. Most of these states are below the median in terms of GDP per capita and have attracted little or no venture capital from traditional sources.*

Table 1 presents a summary of our findings. As of May 2004, eighteen states have a tax credit program in place. Sixteen states have either direct or seed capital tax credit programs. Notably, most states do not have both direct and seed capital programs; our survey found only three such states.

**Table 1**

| State | Direct | Seed Capital | Contingent | 2003 VC Invmts. ($ million) | 2003 GDP Per Capita ($) |
|---|---|---|---|---|---|
| Arkansas | X | | X | * | 24,289 |
| Colorado | | X | | 620.9 | 34,283 |
| Hawaii | X | | | * | 30,913 |
| Indiana | X | | | * | 28,783 |
| Iowa | | X | X | * | 29,043 |
| Kansas | X | | | * | 29,953 |
| Kentucky | | X | | * | 26,252 |
| Maine | X | | | * | 28,831 |
| Michigan | | | X | 103.9 | 30,439 |
| Missouri | X | X | | 120.2 | 29,252 |
| New York | X | | | 650.9 | 36,574 |
| North Dakota | X | X | | * | 29,204 |
| Ohio | X | | X | 93.1 | 29,944 |
| Oklahoma | X | | X | 56.9 | 26,656 |
| South Carolina | | X | X | 46.2 | 26,132 |
| Utah | | | X | 101.1 | 24,977 |
| West Virginia | | X | | * | 24,379 |
| Wisconsin | X | X | | 44.1 | 30,898 |
| **Total** | **11** | **8** | **7** | | |

Source: 2003 PWC Moneytree Survey, Bureau of Economic Analysis

Analyzing these states in terms of geography, per capita GDP, and amount of venture capital investments yields further insights. Highlighting some general trends, most states with tax credit programs are found in the Midwest and Mississippi Valley region. These states also had a GDP per capita below $30,192, the national median in 2003.[1] However, the majority of these states are not the poorest in the nation. Finally, almost all the states have very little venture capital investment. Only two states reported 2003 investments of more than $125 million: New York and Colorado.[2]

These two states are exceptions in other ways as well. New York and Colorado have high levels of venture capital investment – about $657 and $621 million respectively, the fifth and sixth largest amounts in the nation. In terms of per capita GDP, they are also among the ten wealthiest states. However, both these states do aim these programs squarely at their most distressed and under-capitalized areas: New York's tax credit program is limited to 71 designated "Empowerment Zones," which are economically distressed regions. Similarly, in order to be eligible for Colorado's seed capital fund tax credit, the fund must commit to invest 25% of their capital in distressed urban communities and 25% in designated rural communities.

[1] Bureau of Economic Analysis.
[2] 2003 Venture Capital MoneyTree Survey, PricewaterhouseCoopers.

**2. *The policy window for tax credit programs appears to be open, as many states have passed programs in the last five years.***

Most state tax credit programs – in their current forms – have been enacted in the last five years and appear to be gaining traction. States have started seventeen tax credit programs during this period, of which nine were passed in the past year.

There are discernible trends of popularity among the three tax credit models as well (refer to Table 2). Of the eleven states with direct programs, seven states passed policies since 1999, with both Kansas and Wisconsin passing legislation in the last twelve months.

**Table 2**

| | Started between | | |
|---|---|---|---|
| | **2003-2004** | **1999-2002** | **Before 1999** |
| Direct | 2 | 5 | 3 |
| Seed Capital | 2 | 3 | 2 |
| Contingent | 5 | 0 | 1 |
| **Total** | **9** | **8** | **6** |

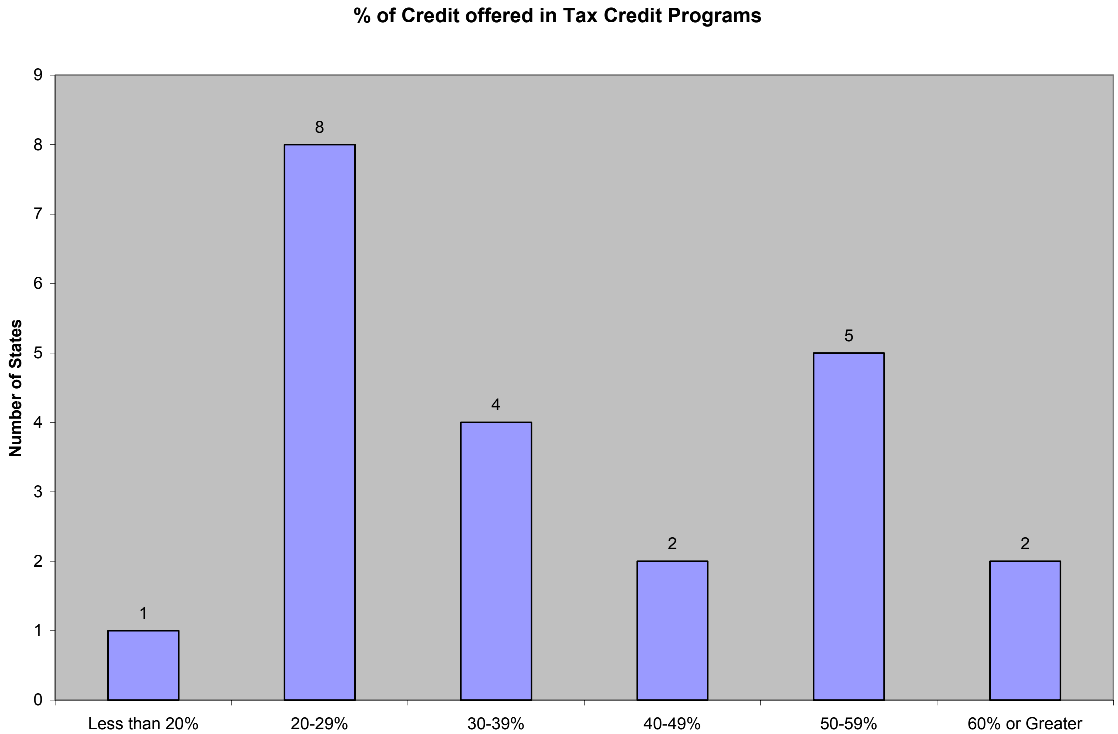
Note: This information does not cover all programs, as we could not find the year of inception for all programs.

Contingent tax credit programs, however, constitute the most recent wave of tax credit programs. Within the past year, the number of states with contingent tax credit programs grew to seven, a significant increased compared to twelve months ago, when only one state had such a program.

**3. *Tax credits can be structured in a number of ways to meet state objectives. Some of the tools policymakers can use include: percent of credits per investments; geographic and industry restrictions.***

Most direct and seed capital fund tax credits range from 20 – 40% of the investment, but programs in two states are exceptions: Hawaii, and Maine.

**Figure 1**




Note: Total greater than eighteen because programs offered different credits for investments in specific areas or businesses.

Hawaii and Maine offer credits of 60% or more. Maine offers a 60% credit over four years for investment in designated areas of high unemployment. Budget concerns caused Maine's legislature to suspend the availability of new credits for the 2004 fiscal year.

Hawaii offers a 100% tax credit for investment into high-technology businesses that can be applied over a five-year period. Several years ago, Hawaii offered investors a 10% investment tax credit, but it generated a disappointing level of investment. As a result, the state increased the credit to 100%. Hawaii's Department of Taxation estimates that the new program will cost the state $48.4 million in fiscal 2003 and $64.7 million in 2004. By far the richest tax incentive offered in the nation, the state is currently auditing approximately one-third of all claims for credits over the past two years, with the concern that many credits were allocated to industries that did not create permanent jobs, such as movie and television production. The program was scheduled to expire in 2005, but was extended to 2010 with new restrictions on qualifying businesses.

In our research, we did not find a study analyzing whether the amount of a tax credit affects the decision to invest. Larger credits clearly create greater incentives to invest, but whether a credit of any size results in incremental investment above what would have occurred without the credit is an unanswered question. State legislators likely set credit amounts by weighing several factors, including past experience, similar efforts in neighboring states (which may be largely anecdotal), the perceived need for capital formation and budget concerns.

Aside from adjusting the tax credit amount, states often add eligibility restrictions on the types of businesses in which people or venture funds invest. These qualifications usually establish tax credits for specific industries or regions. Lately, many programs have targeted investments to the high technology industry, as indicated by the three states with such tax credits in our survey. Ohio, in particular, created a very structured program to meet its objective of spurring high-tech investments, the Ohio Technology Investment Tax Credit Program. To qualify for the credit, companies must satisfy the following conditions: (1) be a business that is primarily focused on research and development, technology transfer, or the application of new technology; (2) have gross revenues of less than $1 million, or a net book value of less than $1 million at the end of the most recently completed fiscal year; (3) have Ohio as its principal place of business and at least half of its gross assets and employees located in the state; and (4) have less than $1 million in investments that have already qualified for the tax credit.

Interestingly, some states have taken a completely opposite approach, structuring their programs to permit broader, less defined investments. Maine's program was specifically designed to permit some investment flexibility. To qualify for Maine's Seed Capital Tax Program businesses must be either a (1) manufacturing business; (2) a company that develops or applies advanced technologies; (3) a product or service provider that generates more than 60% of revenues from outside Maine; or (4) a company that brings significant permanent capital into the state during the course of business. The last condition's somewhat ambiguous language – "company that brings significant permanent capital into the state" – was included so the Finance Authority of Maine could have flexibility in approving businesses for investment. As such, the Finance Authority has the opportunity to qualify potential revenue-generating businesses outside their initial scope, as necessary.

Finally, some states have included a measure in their programs that allow tax credits to be sold or transferred to third parties. Missouri and Arkansas have such a feature. To this day, however, the impact of transferable tax credits remains uncertain. There was little evidence from our survey suggesting a secondary market for tax credits has developed or any significant amount of credits have been transferred.

**4. *Despite outreach efforts, some programs have experienced shortfalls between their allocated and actual tax credit disbursements.***

Our survey found nearly half of states with direct tax credit programs experienced shortfalls between their anticipated and actual tax credit disbursements. These include Arkansas, Indiana, Iowa, Kentucky, Missouri, North Dakota and Oklahoma.

There are several possible explanations for the gap between the allocation and disbursement of tax credits. First, organizers of seed and venture funds may have difficulty closing funds in under-invested regions. For example, Kentucky allows venture capital funds to apply for tax credits either before or after the funds raise capital. Last year, the state's $3 million in tax credits was allocated to four venture capital firms. However, since then, one of the firms has failed and two have not yet closed their funds. One fund was successfully organized but has yet to make the required investment to trigger tax credit disbursements to investors.

Second, investors may face limited investment opportunities – deal flow likely is limited in areas that are not traditionally "entrepreneurial." Some states are addressing this problem. Maine's Finance Authority has established a relationship with the Maine Technology Institute, which first funds the initial phase of new ideas or projects and then transitions them to Maine's angels for later stage investments. Additionally, Ohio and Arkansas have dedicated efforts to reach out to entrepreneurs, and educate them about the availability of tax credits to help fund their businesses.

Third, local investors may be unfamiliar with equity investing, and extra efforts will be required on the part of state administrators to educate them. Related to that point, several states reported concerns that uptake problems were the result of a dearth of experienced equity investors. Newer angel investors and networks may not have the equity investing experience and expertise to conduct due diligence and manage investments and portfolios in the most efficient way. Iowa is a case of a state working to address this problem. Iowa's Department of Economic Development is working to establish itself as a resource for the state's new seed capital funds' investors. The Department is considering establishing a central resource of experienced equity investors to conduct the necessary due diligence for the state's seed capital funds. In addition, it has devoted a great deal of time over the last several years to educating and helping local investors set up seed capital funds. To date, after this patient effort, ten such funds have been established in Iowa, and twelve more groups are considering establishing these funds.

Notably, most states feel their marketing techniques have enabled them to reach almost all their potential angel and venture capital investors. This differed significantly from our initial hypothesis drawn from a focus group conducted at the CDVCA's Annual Conference. In fact, eight of the sixteen states with incentive tax programs expressed satisfaction with the marketing of their programs. These states generally leveraged two techniques to market their programs: directly reaching out to known investors; and capitalizing on word-of-mouth sharing. Most states use their local Chamber of Commerce, various venture capital associations and networks as resources to market tax credit programs. Oklahoma has reached out to its *Society of CPAs* and various manufacturing councils to market its tax credit programs. Officials in Ohio reach investors by speaking at various functions frequented by potential investors such as Chamber of Commerce events and venture capital and angel conferences. Ohio also has reached out to the state's lawyers and accountants. Moreover, almost all states, even ones that did not cite successful marketing, claim word-of-mouth as one of the most effective ways to market the programs. As most states with angel and venture tax credits have developing venture capital environments and nascent angel networks, potential investor communities are very small. Most program administrators expressed their belief that simple efforts, such as an email from a Kentucky attorney to his own venture capital network, are sufficient to quickly and efficiently advertise the program to potential tax credit recipients.

On a final note, increasing tax credit activity can be as easy as making tax credit forms more accessible to investors. For example, officials in North Dakota reported an increase in tax credit applications when the state moved its seed credit claim from the long state personal income tax form to the short form. Sometimes the most effective changes are the simplest.

5. ***Not all states are tracking program effectiveness. This not only limits a state's ability to improve programs mid-way but also makes programs vulnerable to changing political environments.***

Our survey results indicate that about half of the states with tax credit programs have instituted measures to evaluate their programs. To be fair, time is a significant obstacle in these efforts. After a program is enacted, evaluators must wait for investments to close. Then, they have to wait until investors file their tax returns. Further, this information has to be processed and disseminated. And finally, the ultimate success of a tax incentive program may appear years later. Despite these challenges, a few states plan to track their tax credit programs. Iowa, for example, will examine the number of seed capital funds established, the number of jobs created and the success of the investments by the funds.

Other states have been forced to track their programs. In Missouri, concerns that the tax credit programs were proving costly resulted in the recent passage of the Tax Credit Accountability Act of 2004, which requires tax credit recipients to comply with additional reporting requirements. Also, three audit positions have been added to Missouri's Department of Economic Development for fiscal year 2005 in order to develop a tax credit and incentive compliance unit.

Further, in the few cases where results have been collected and tabulated, the cost effectiveness of these programs is mixed. Missouri recently conducted an analysis of its New Enterprise Creation Tax Credit ("NECA") programs. The NECA program established the Missouri Seed Capital Investment Board and provided for $20 million in tax credits. Investors in a seed capital fund with investment restrictions are granted a 100% tax credit for each dollar invested, provided that they also invest the same amount in another, less restrictive fund (effectively a 50% tax credit). The recent analysis by the state auditor suggest the program will not generate enough economic activity to offset the state tax credits used. While the program is expected to use $16.8 million in tax credits, it is predicted to generate only $7.3 million in state revenues, thereby costing the state $9.5 million.

The Hawaii Department of Business Economic Development and Tourism reported significant benefits from Act 221 (its tax credit program): the creation of 600 technology jobs at an average salary of $46,000, a wage very close to the $50,000 living wage required to fundamentally change the state's economy.[3] However, as previously discussed Hawaii is currently auditing nearly one-third of all its tax credit claims over the past two years.

[3] "State says Act 221 created 600 tech jobs," Pacific Business News, April 2, 2004.

This issue is further complicated by interviews that suggest several states prioritize other qualitative benefits of tax credit programs over typical program effectiveness metrics such as job creation and tax revenue collection. For example, Arkansas officials expressed the view that their tax credits may assure investors of the viability of in-state investments and thus spur overall investor confidence and investment (including increased venture capital activity). Similarly, administrators in Indiana view their tax credit program as a method to encourage an entrepreneurial environment in the state. Finally, some states such as Maine even consider the tax credits as loss leaders, helping the state attract and foster external investment.

Still, given these programs are new and developing, it is our view that only with proactive early monitoring can states iterate and improve their programs to ensure funds are allocated for their intended uses and meet state objectives.

Moreover, states must consider the political implications of not evaluating tax programs. As with any public policy program, incentive tax credit programs are vulnerable to a state's changing political environment. Therefore, many of these programs will eventually – if not already – compete for priority among other public policy issues amidst state budget deficits. Without effective short-term metrics that demonstrate program achievements, tax credit advocates can find it difficult to enlist policymakers to support program renewals and extensions.

In order to secure political support, states need to begin developing and implementing long- and short-term metrics. Potential metrics include changes in deal flow and venture activity (e.g., more angel conferences, increased angel group professionalism, angels investing through a common checkbook, venture capital networks, etc.). But along with developing short-term evaluation metrics, states must help legislators understand these new evaluation metrics. Arkansas, for instance, has begun inviting legislators to its VC forums to help increase their overall understanding of equity investing and reasonable returns. Also, simply holding these forums demonstrates the progress of its tax credit programs to legislators. Long-term metrics include incremental levels of venture investment, co-investment activity, job creation, job retention and incremental tax revenue collections.

## III. NEW DEVELOPMENTS: CONTINGENT TAX CREDITS AND FUND OF FUNDS PROGRAMS

Seven states, Arkansas, Iowa, Michigan, Ohio, Oklahoma, South Carolina and Utah, have adopted programs authorizing the issuance of tax credits to investors in state-sponsored fund of funds. In the event the fund of funds is not able to provide the investors with a promised fixed rate of return from the profits of its investments, the tax credits are activated. The fund of funds uses the proceeds to invest in venture funds that it selects based on a request for proposal-style process, choosing funds that promise to invest or consider investing in that state.

All of these programs have been adopted in the last four years, with the exception of Oklahoma's program. Oklahoma established the Oklahoma Capital Investment Board ("OCIB") in 1992 in order to mobilize venture investment in the state. OCIB, through the Oklahoma Capital

Formation Corporation ("OCFC"), operates as a fund of funds with the backing of a $100 million commitment from the state to grant tax credits against income or premium taxes in the event it should fail to provide a promised return. OCIB can invest in funds nationwide, and seeks funds with "an appetite for investments that are likely to exist or emerge in Oklahoma" and "a solid plan for aggressively addressing the Oklahoma market." The OCIB reports that as of June 2002 it had contributed $27.3 million to funds that have invested or co-invested $89.9 million in Oklahoma firms. No tax credits have been redeemed. The results of Oklahoma's program were cited by legislators adopting similar programs in Ohio, Michigan and Iowa.

States may be attracted to these programs because they have the virtues of mobilizing capital on a large scale while not immediately draining state coffers of tax revenue, as was the case for the numerous states that adopted certified capital company (CAPCO) programs. Also, these programs can be shaped in a manner that will preserve more of the market-based incentives that make venture funds powerful economic development tools by asking that the investee funds also have substantial amounts of their own capital at risk. South Carolina's program, for example, requires that when selecting a venture fund, the fund of funds give preference to venture funds with aggregate capital commitments of at least three times the amount of the state fund of fund's potential commitment. Hopefully, states with new programs will specify short and long-term metrics to measure their impact and share these results.

## IV. CONCLUSIONS

Findings highlight several critical lessons that should help both state administrators and potential investors shape effective incentive tax programs and policy.

1. *While there is not one successful program model, there is a general consensus about certain program implications.*

   To use an apt metaphor from one of our interviews, the various models and their particular specifications are "tools" that states can use to achieve many objectives. These tools are best suited for specific tasks; using them otherwise may lead to unfavorable results. Below are several of the tools that states can use in developing a tax credit policy.

   **Table 3**

| Tool | Use |
|---|---|
| Direct incentive credits | Encourage investment from angels and angel networks |
| Seed capital incentive credits | Encourage investment from seed capital funds and venture capital firms |
| Tax credit amounts (as % of investment) | Affects returns for investments. Balance needed between providing incentive without perverting decision |

| | |
|---|---|
| | processes |
| Targeting specific regions or industries | Steers equity (and near equity) investment into selected areas |
| Contingent tax credits (in fund of funds) | Helps to raise money for state-affiliated venture capital initiatives without impacting state revenues |
| Transferable credits | Unproven |

Our research suggests that these are the consensus uses for these tools. As such, involved tax policy stakeholders should understand these tools, their particular uses and how to leverage them to meet specified objectives.

2. *States should continue to seek effective methods for private sector involvement.*

   Tax credit programs are a public-private partnership in which the state provides financial incentives to the private sector to increase equity investment in a region. As such, private sector involvement and consensus is critical during program development stages. Further, potential investors and entrepreneurs goals should be aligned with program objectives from program development to implementation.

3. *Education of investors, entrepreneurs and state policymakers is critical to program uptake.*

   Low levels of familiarity of investors, entrepreneurs and state policymakers with overall equity investing, and direct and indirect tax credits have contributed to limited incentive program uptake. Therefore, states must in part focus on the developing the appropriate approach to attracting venture capital and thereafter focus on educating key parties. Only with education can these new investors infuse the economy with their capital and unfamiliar legislators have the patience to maintain support for incentive programs until tangible benefits materialize.

4. *Both short-term and long-term program evaluation metrics are key to ensuring program improvement and continuation.*

   Political pressures will challenge states to develop both long-term and short-term (e.g., annually or bi-annually) program evaluation metrics. Short-term metrics will not only aid legislators advocating on behalf of such programs, but also educate and encourage investors to contribute capital to their communities. Though difficult to conceptualize, there are several short-term metrics that could serve as a proxy for an increase in equity investing. Some examples are the number of angel forums, attendance at tax credit sessions, and the emergence of out of state investors as interested parties in VC investments.

5. *Developing tax credit programs is an iterative process.*

Most state tax credit programs have recently been enacted in the last several years. Further, tax credit programs, like any new policy programs, will result in unexpected challenges and consequences. As such, investors, legislators and administrators must have the patience and understanding to improve programs based on these challenges.

## APPENDIX A: DIRECT TAX CREDIT PROGRAMS

| | Year Started | Total Credit (%) | Investment Size Min ($) | Max ($) | Annual Claim on Investment Limit (% or $s) | Length of Program | Carry Forward Period (yrs) | Certified | Notes |
|---|---|---|---|---|---|---|---|---|---|
| ARKANSAS | 2003 | 33% | | | 50% of investor's annual tax liability | | 8 | | Program enacted in 2003; flexible annual cap of $10M; investors can not cash the tax credit for two years; tax credit is transferable. Dividends, distributions and income allocable to the investment are exempt from state, county and municipal income tax. |
| HAWAII | 2001, significantly expanded the program | 100% credit applied over a five-year period | | | 35% in year investment was made, and then 25%, 20%, 10%, 10% subsequently each year thereafter; can not claim more than $2 million per year per qualified high-tech business | Sched. To expire n 2005, recently extended to 2010 w/ new restrictions | | | Enacted under Act 221; business investment tax credit available for each investment in a "qualified high technology business"; non-refundable credits; if business is sold or withdrawn in any year during the 5-year period, there will be a recapture of 10% of the total tax credit claimed in the preceding two taxable years |
| INDIANA | 2002 | 20% of investment | | | $500,000 | Investments made after 12/31/2003 and before 12/31/2008 qualify | 2 | | VCI Tax Credit enacted during 2002 Special Session and updated in 2003 regular session; annual cap of $10M; disbursed $5.7M in credits since 01/04; must invest in a "Qualified Indiana Business" - independently owned and operated business that is certified as a qualified Indiana business by the IDOC; if investor does not have state tax liability can pass credit to shareholders, partners or members |
| KANSAS | 2004 | 50% | | | Investor can invest in as many as five companies in a given year with a maximum allowable tax credit of $250,000 | 01/01/2005-12/31/2015 | | | Kansas Angel Investor Tax Credit Act passed on 04/12/2004 - funds rolled over from ineffective certified capital formation tax credit passed previously, state also passed similar tax credit legislation in the late 1990s; available to investors who invest in early stage technology companies; investors must be accredited under SEC, and invested companies must also be certified by KTEC; annual $2 million cap |
| MAINE | before 2000 | 40% statewide; 60% in state designed areas with high unemployment | | | 25% increments over 4 years, but can not reduce more than 50% of investors tax liability in a given year | | 15 | | Overall program cap of $20M; program been in place before 2000; mostly angels investing but can be used by venture capitalists |
| MISSOURI | 1986 | | | | $1 million per investor, not annual | Program passed in 1986, all credits allocated, expect $500,000 to be redeemed in 2004 and $500,000 in 2005 | | | Seed Capital Tax Credit Program established in 1986, cumulative cap of $9 million has been exhausted in 1999; limited amount of tax credits are transferable |
| NEW YORK | N.A. | 25% | | 400,000 | | | | | Available in Empire Zones (limit of $100,000 credit), designated zones for economic development; Maximum amount of investment for which 25% can be applied is $400,000. |
| NORTH DAKOTA | 2001 | 45 | 5,000 | 250,000 | 33% | | 4 | X | Seed Capital Investment Credit. Had been on books for a while but credit transferred to short form on personal income tax form in 2001, which led to considerable increase in usage. Recently increased amount of credit to 45% (orig. 30%). Amount of tax credits allowed only $1mm through 2002, afterwards it increases to $2.5mm |
| OHIO | 1996, recently added tax credit for economically distressed areas | 25%/30% | | 150,000 | | | | X | Technology Investment Tax Credit Program for qualified, technology based companies (25%).Recently added 30% tax credit for qualified minority businesses in economically distressed counties |
| OKLAHOMA | original one was started in 2000, rural program initiated in 2002 | 20%/30% | | | | 2000 - 2008 | 10 | | Small Business Capital Formation Tax Credit: Original program provided 20% tax credit for businesses; Earned credit can be taken annually up to 10 years.; Rural Small Business Capital Formation Tax Credit (30% credit) added in 2002 upon lobbying from rural business professionals (credits available 12/31/2001 to 1/1/2008; Both programs allow for equity or near equity investment, no holding period, no change in taxable basis, no recapture |
| WISCONSIN | 2004 | 12.50% | | | | 2004 through 2014 | | | Legislation just passed (April 2004); program also includes an indirect incentive credit; State budgeted $6.5mm year to be used for both programs |

## APPENDIX B: SEED CAPITAL TAX CREDIT PROGRAMS

| | Year Started | Credit (%) | Annual Claim on Investment Limit | Length of Program | Carry Forward Period (yrs) | Notes |
|---|---|---|---|---|---|---|
| COLORADO | 2004 | | | | | Senate Bill 106 passed (3/4/04) to replace ineffective CAPCO program with venture capital tax credit program; targeted funds: 50%, general statewide businesses; 25%, distressed urban communities; 25%, designated rural counties |
| IOWA | 2002 | 20% | | 2002-2004 | credit can be claimed 3 years after to the investment, and carried forward 5 years thereafter | Seed Capital Investment Credit passed in 2002; Seed capiutal fund must be capitalized at a minimum of $500,000, have qualified investors, and invest in 2 qualified companies in 3 years to apply for Iowa tax credits; $10M total cap on credits; roughly $250,000 disbursed thus far. While legislation also offers tax credits to individual investors, interviews suggest the primary focus has been RAIN funds, not individual tax credits |
| KENTUCKY | 2002 | 50%, total qualified investments made by a single investment fund not to exceed 30% of the cash contributions to the investment fund | | Expires in 2004, enacted many years previously, only somewhat effective | 15 | Kentucky Investment Fund Act (KIFA) rewritten 2 years ago; $20 million cap on overall program, $3M cap for 2003 $3M cap for 2004; direct credits to investors and business who invest in approved investment funds; fund's stated purpose must be to primarily encourage and assist in the creation, development and expansion of small businesses located in Kentucky; fund loses credits available to investors if does not invest accordingly to KEDFA agreement |
| MISSOURI | 1989 | 50% | | | 5 | Small Business Incubator Tax Credit Program established in 1989 for contributions to approved incubator funds; annual cap of $500,000 approved annually; transferable tax credits; in 2003 only $90,000 disbursed with projections for 2004 and 2005 of $450,000 |
| NORTH DAKOTA | N.A. | 25%, if investments are greater than $1 million, credit is capped at $250,000 | | | 7 | Credit for investment in a North Dakota Venture Capital Corporation |
| OKLAHOMA | approx. 1992 | 20% | none | | | Venture Capital Tax Credit - VC must have capitalization of $5 million and must invest 55% of fund in qualified OK companies over a 10yr period |
| SOUTH CAROLINA | approx. 1987 | 30%/50% - credit is actually determined by a formula: lesser of (a) 30% of all qualified investments during the tax year or (b) 50% of all qualified investments during all tax years multiplied by 30% | | | 10 | (Palmetto Seed Capital Credit) Program has been on SC books for a while but never really utilized and is being phased out. Credit did have recapture provision for investments exited earlier than 5 years |
| WEST VIRGINIA | 2002 | 50% | 2,000,000 | | | West Virginia Capital Company Credit. Capital companies must have at least $1M in capital but no more than $4M. State authorized $10M in credits, with an annual limit of $2M per year |
| WISCONSIN | 2004 | 25% | | 2004 through 2014 | | Legislation just passed (April 2004), program also includes a direct incentive credit. State budgeted $6.5mm year to be used for both programs |

## APPENDIX C: CONTINGENT TAX CREDIT PROGRAMS

| State | Year Started | Name of Program | Notes |
|---|---|---|---|
| ARKANSAS | 2001 | Arkansas Institutional Fund | Total credits: $70m; Banks have agreed to purchase $60m worth of tax credits |
| IOWA | 2004 | Iowa Capital Investment Board | $100 million allocated, not redeemable for first 5 years of program, credits are transferable. Investee funds must commit to "consider equity investments in businesses in Iowa and maintain a physical presence in Iowa." Manager selected in April 2003, Great River Capital LLC, jv between an affiliate of Dresdner Bank and local investors. |
| MICHIGAN | 2004 | N.A. | Total credits: $150m; No credits can be assigned in the first five years; afterwards $30m credits per year. |
| OHIO | 2004 | Ohio Venture Capital Authority | Total credits: $100million allocated, advisor recently selected, expected to begin investing in 2005. |
| OKLAHOMA | 1992 | Oklahoma Capital Investment Board | One of the oldest contingent programs; Legislature has authorized $100 million in credits to back investors, none utilized to date, credits expire 2015.As of 2002, OCIB had invested $27.3 million into vc funds. |
| SOUTH CAROLINA | 2004 | Part of 2004 Life Science Bill | $100 million allocated, Fund of funds to give preference to vc fund having 3 times FOF's commitment, all selected funds must have at least 100% of FOF commitment. Legislation currently being challenged in court as being part of a "kitchen sink" package. |
| UTAH | 2003 | Utah Venture Capital Enhancement Act | Total credits: $100m; Annual Limit: $20m; Recently passed, criteria for evaluating program and financing terms have not been established; Developed a "designated purchasers" program in which an investor agrees to buy certificates of tax credits; Wanted nontraditional investors (e.g., utility companies) to finance fund of funds |

## APPENDIX D: 2003 STATE GDP PER CAPITA AND VC INVESTMENTS (RANKED BY VC INVESTMENT)

| State | VC Investments ($mm) | GDP per Capita ($) |
|---|---|---|
| CALIFORNIA | $7,652.7 | $33,749 |
| MASSACHUSETTS | 2,482.7 | 39,815 |
| TEXAS | 1,165.9 | 29,372 |
| NEW JERSEY | 810.4 | 40,427 |
| NEW YORK | 650.9 | 36,574 |
| COLORADO | 620.9 | 34,283 |
| PENNSYLVANIA | 538.4 | 31,998 |
| ILLINOIS | 401.5 | 33,690 |
| WASHINGTON | 385.1 | 33,332 |
| NORTH CAROLINA | 368.3 | 28,235 |
| GEORGIA | 344.3 | 29,442 |
| VIRGINIA | 343.7 | 33,671 |
| MARYLAND | 340.3 | 37,331 |
| CONNECTICUT | 253.2 | 43,173 |
| FLORIDA | 230.0 | 30,446 |
| MINNESOTA | 203.8 | 34,443 |
| NEW HAMPSHIRE | 156.0 | 34,702 |
| MISSOURI | 120.2 | 29,252 |
| MICHIGAN | 103.9 | 30,439 |
| UTAH | 101.1 | 24,977 |
| OREGON | 99.0 | 29,340 |
| OHIO | 93.1 | 29,944 |
| DISTRICT OF COLUMBIA | 88.1 | 48,342 |
| IDAHO | 73.8 | 25,911 |
| ARIZONA | 71.8 | 26,838 |
| TENNESSEE | 63.7 | 28,455 |
| OKLAHOMA | 56.9 | 26,656 |
| SOUTH CAROLINA | 46.2 | 26,132 |
| WISCONSIN | 44.1 | 30,898 |
| RHODE ISLAND | 42.3 | 31,916 |
| ALABAMA | * | 26,338 |
| ALASKA | * | 33,568 |
| ARKANSAS | * | 24,289 |
| DELAWARE | * | 32,810 |
| HAWAII | * | 30,913 |
| INDIANA | * | 28,783 |
| IOWA | * | 29,043 |
| KANSAS | * | 29,935 |
| KENTUCKY | * | 26,252 |
| LOUISIANA | * | 26,100 |
| MAINE | * | 28,831 |
| MISSISSIPPI | * | 23,448 |
| MONTANA | * | 25,920 |
| NEBRASKA | * | 30,758 |
| NEVADA | * | 31,266 |
| NEW MEXICO | * | 25,541 |
| NORTH DAKOTA | * | 29,204 |
| SOUTH DAKOTA | * | 29,234 |
| VERMONT | * | 30,740 |
| WEST VIRGINIA | * | 24,379 |
| WYOMING | * | 32,808 |

Note: * indicates not in the Top 30

Source: PWC 2003 MoneyTree Report, www.pwcmoneytree.com/exhibits/Q403MoneyTreeReport.pdf
Bureau of Economic Analysis, Press Release - Average Income Growth Improved in 2003, www.bea.gov

## APPENDIX E: RESEARCH METHODOLOGY

Primary research was conducted in two stages. The first stage involved identifying potential states with direct and indirect incentive tax credit programs. In this process, we first searched official state websites, the National Association of Seed and Venture Fund's (NASVF) online database of state programs, and other news databases such as Lexis-Nexis and Factiva. Further, we also double-checked the top twenty states with venture capital activity identified by the *Progressive Policy Institute's State New Economy Index* (2002) and/or any states referenced in RUPRI's *Directory of State-Assisted Venture Capital Programs* (2000) for tax incentive programs. Once potential states were identified we conducted structured interviews with key state and non-state personnel. Typical interviewees were program administrators and legal counsels working for or with state Department of Commerce, Revenue and/or Economic Development divisions. Leading state and national researchers in the community development venture capital field were also interviewed. As such, unless otherwise noted, interview results and state program materials and legislation form the basis for our findings.

Our research approach focused primarily on qualitative phone and email interviews. While acknowledging our study as an effort to provide a comprehensive review of current, active tax credit programs, as researchers, we feel it would be prudent to mention a few caveats with this approach. First, time constraints limited our ability to conduct an exhaustive analysis on state tax credit programs; we primarily spoke with state administrators, but did not have the time to follow-up with entrepreneurs and investors – the users of tax credits. However, since state administrators were usually in contact with members of these communities, we believe their perspectives were generally reflected through state administrators' comments. In addition, several state officials were new to their positions and were neither able to answer specific questions nor provide a historical context for their tax credit programs. This fact, along with the nascent conditions of state programs, sometimes limited the amount of information we could gather. This particularly applies to contingent tax credit programs, most of which are still in very early stages of implementation. Nevertheless, we believe our research findings do provide a comprehensive survey of incentive programs.

## APPENDIX F: ABOUT THE AUTHORS

**Amy Chung** is a student at the John F. Kennedy School of Government and the Kellogg School of Management. Before graduate school, she was a senior consultant at Cap Gemini Ernst & Young for three years. She graduated from Northwestern University in 1999, with a dual degree in Economics and Urban Studies.

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**Kelly Williams** has been a consultant at the Community Development Venture Capital Alliance in New York City since 1999. She is the author of a CDVCA white paper for the Rockefeller Foundation, Involving Traditional Angel and Venture Capital Investors in Community Development Venture Capital (2000), and a book on angel investing and community development, Working with Angel Investors for Community Development: Analysis, Best Practices and Case Studies (CDVCA 2003). Ms. Williams was an attorney specializing in corporate finance at Cleary, Gottlieb, Steen & Hamilton in New York for six years, and then legal counsel for the Union Bank of Switzerland. She graduated from Tufts University and New York University School of Law.