# Tax Credits and Government Incentives for Angel Investing in Various States[1]

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## Abstract

This paper describes the characteristics of angel tax credit programs and explains in detail how Hawaii, Kansas, Wisconsin, and Kentucky have implemented and monitored their respective programs. For states seeking to implement or improve angel tax credit programs, research suggests that administrators should direct their energies and resources in building relationships, educating investors and entrepreneurs, and increasing the visibility of angel networks to entrepreneurs. In addition, involvement by science and technology councils and research universities can enhance the effectiveness of these programs.

In the past decade, more than 20 states have implemented programs to attract or retain investment capital by way of income tax credits. (See Appendix A for a list of states with angel tax credit programs) The purpose of angel tax credits is to reduce the risk and cost of angel investing in order to encourage more entrepreneurial activity in high-growth small businesses. The theory is that if successful, these programs can attract investment dollars, create jobs, and contribute to the economic growth of the state. How can a state tell if its angel tax credit program is fulfilling its purpose?

Tax credits represent a dollar-for-dollar reduction of the investor's tax liability. These tax benefits can be structured as refundable credits or nonrefundable credits. Refundable credits have greater potential value to the taxpayer, because when the taxpayer has a credit greater than the tax liability, the state will pay the balance to the taxpayer. However, most angel tax credits are nonrefundable. Though the maximum benefit of a nonrefundable credit is to eliminate a taxpayer's income tax liability, all excess credit is not necessarily lost. Nonrefundable tax credits in excess of an investor's income tax liability are either lost or carried forward to offset future tax liabilities, depending on the particular state's provisions. Most states with an angel tax credit have provisions for a carry forward period. In addition, in some states, tax credits can be transferred to benefit other taxpayers, if certain conditions are met (Pope, et al, 2008).

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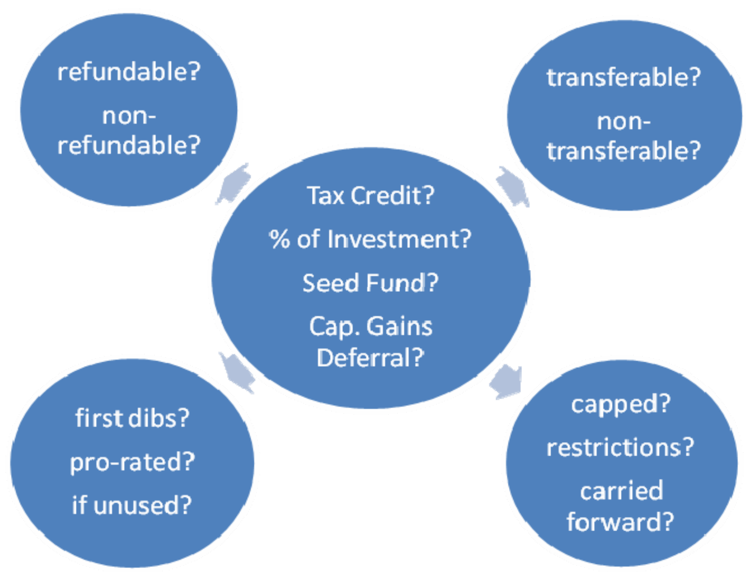
As state legislatures have the latitude to choose the parameters for any policy incentive, no two programs are identical. For example, one program offers 100 percent credits for investments while others are considered to offer minimal incentives. Some are purely governmental in structure while others are a public/private hybrid. Some are tax credits, some are seed funds. Some are deferred capital gains credits, some are transferable, non-transferable, carried-forward, capped annually, capped over many years, and more. Simply the nomenclature of these targeted angel investment incentives can be tricky, with such varieties as: "Angel Investment Tax Credit," "High Technology Investment Tax Credit," "Qualified Business Investment and Seed Capital Tax Credit," "Venture Capital Investment Tax Credit," "High Growth Business Investment Credit," and on and on with versions of these themes. What one state labels as "seed," another will call "venture," and yet another will call "angel"—and there might not be much qualitative difference from the individual state's perspective. The lack of uniformity among the states makes it difficult to compare and evaluate the impacts of these programs.

**Possible Characteristics of Angel Tax Provisions**




The purpose of this paper is to investigate four state angel tax credit programs that fall along the continuum of existing angel tax credit programs as a means of better informing angel investors and policy makers who are considering angel tax credits in their states. This paper offers an in-depth perspective on how Hawaii, Kansas, Wisconsin, and Kentucky are managing their respective goals of economic development through their credits and incentives for angel investing. This paper is organized as follows:

- The first two sections describe the methodology used in gathering information, including prior studies, and how the sample states were selected.

- The next section presents the tax provisions of the four sample states.
- The final section includes conclusions and considerations for states attempting to adopt new angel investing programs or to improve their existing programs.

## Prior Studies and Methodology

In February 2008, the National Governors Association (NGA) published "*State Strategies to Promote Angel Investment for Economic Growth*," which included a statement that tax credits can be controversial. The report explains that part of the controversy is the "lack of data and the difficulty of measuring economic impacts," as well as the uncertainty that such incentives improve deal quality. The report identifies states with tax credit programs and summarizes examples of states' related public policy actions. Though the report does not draw finite conclusions about the programs' successes, it optimistically concludes that the "benefits of supporting and encouraging angel investment can be great."


The National Association of Seed and Venture Funds (NASVF) May 2006 report "*Seed and Venture Capital: State Experiences and Options*" includes an analysis of the qualities that should guide states' capital investment incentive programs. According to this report, successful states should structure programs that have the following characteristics: the credit should be financially fair to the state, sizable enough to be substantially effective, and managed at the discretion of experienced professionals in the private sector. A program's strong leaders and champions should be profit-motivated, target the knowledge-based industries, and constantly evaluate the program to the extent possible. Through this targeting, the credit should have a narrow purpose requiring minimum legislation, and the initiative should address a long-term goal.

In an appendix to the NASVF report, entitled "*The Sandler Report: The Effective Use of Tax Credits in State Venture Capital Programs,*" Daniel Sandler cautioned that if a state is going to institute a tax credit for angel investment, it should be well thought-out from both a legal and an economic standpoint. He stressed that a state program should be clear, targeted, well-monitored, and subject to a sunset clause. In a separate study, Canadian Tax Paper No. 108 "*Venture Capital and Tax Incentives: A Comparative Study of Canada and the United States (2004),*" Sandler posited that it is very difficult to gather enough meaningful information to conduct a proper cost-benefit analysis. This difficulty lies in the incalculability of direct, indirect, and induced economic benefits for the state. And during an interview, he maintained that, in spite of these difficulties, states do stand to gain from tax credit programs if the element of risk is not eliminated and a new culture of entrepreneurship takes root.

Because of the limitations of empirical cost-benefit methodology, this paper takes a descriptive approach. Using the prior studies as a backdrop and a starting point, the author engaged in one-on-one interviews with key government officials, angel leaders, and tax experts. In addition to the primary sources of the interviews, much of the information presented in this paper is derived from state websites, public documents, and electronic articles. From these sources, the author composed a narrative that is designed to provide context for understanding the key points of the sample programs. This is not a comparative study of Hawaii, Kansas, Wisconsin, and Kentucky's angel tax credit programs, because this paper does not seek to directly compare one state to another. Given the uniqueness of each state's economy, geography, and culture, to directly compare the states would be a bit like comparing apples to oranges. Rather, this paper seeks simply to present the four programs alongside each other and then identify some traits, goals, and practices that should inform other states considering angel incentive programs.

## Sample States

The four states included in this paper were chosen to provide a representative sample of the existing state tax credits. (See Appendix A for a List of States with Angel Tax Credit Programs) The most prominent differentiating characteristic of a state's program is the generosity of the tax credit. Along the continuum from most generous to least generous, one defining factor is the percentage of the investment made granted as a tax credit. A second factor in differentiating the nineteen states is the nature of the state-imposed credit limits or caps. Using these two factors as a guide, sample state programs could be categorized in high, medium, and low ranges of percentages of investment and the degree of state limitations. The sample states were chosen to be representative of these high, medium, and low ranges, and the following describes the rationale in selecting them.

- **Hawaii** has the most generous tax credit that grants a 100% of the investment made, with a $2 million cap per *business* per year and no total cap.

- **Kansas** has a median total dollar cap per investor per year, selected from all states that grant a 50% tax credit (Kansas, Louisiana, Virginia, and West Virginia).

- **Wisconsin** has a fairly representative cap of $125,000 per investment, selected from all states that have or had a 20-30% credit (Arizona, Indiana, Iowa, New Mexico, North Carolina, Ohio, Oklahoma, and Wisconsin). Also, Wisconsin was noted in the NGA report, as it has a "particularly good method for attracting, vetting, and selecting applicants."

- Lastly, **Kentucky** was selected for its hybrid approach, which provides tax credits to individuals and institutional investors that invest in professionally managed seed or venture capital funds that are approved by the state.

## Characteristics of Angel Tax Credit Programs

| | Hawaii | Kansas | Wisconsin | Kentucky |
|---|---|---|---|---|
| **Name** | **Act 221, High Tech. Business Investment Credit (2001)** | **Kansas Angel Investor Tax Act (2005)** | **Act 255, Angel Investor Tax Credit (2005)** | **Kentucky Investment Fund Act (1998)** |
| **Percentage of investment** | **100%** | **50%** | **25%** | **40%** |
| **Credit timeline** | **Span of five years: 35%, 25%, 20%, 10%, 10%** | **Year of investment: entire 50%** | **Span of two years: 12.5%, 12.5%** | **Not more than 50% of total credit granted in any one year** |
| **Individual limits / caps** | **$2M credit per business per year** | **$50K per investment, 5 per investor per year** | **$250K per investment, split over 2 years** | **$8M lifetime cap per fund** |
| **State limits / caps** | **none** | **$6M per year, expected to stay constant until 2016** | **$3M per year, can borrow from other years if unused** | **$40M lifetime cap for all funds** |
| **Transferability** | **2-to-1 transfer for special-purpose entities** | **Possible to sell credit to a third party** | **Normally non-transferable** | **Normally non-transferable** |
| **Refundability / Carry forward** | **Nonrefundable** | **Nonrefundable, carry forward until all is used** | **Nonrefundable, carry forward up to 15 yrs** | **Nonrefundable, carry forward up to 15 yrs** |

## Hawaii's Singularity

The fiftieth state is unique on many levels, one of which is its current high technology business investment credit. Traditionally, tourism, real estate, and agriculture have driven the Hawaiian economy, and like many states, Hawaii's leaders were interested in diversifying. Hawaii's remote location and high cost of living create a difficult climate to attract new business. At the turn of the twenty-first century, Hawaii's state leaders began taking steps to attract new knowledge-based industries.

**Hawaii**

- 1999 10% credit raised to 100% in 2001
- administered by Dept. of Taxation
- new effort to gather data on companies
- 1999-2005: $195.6M credits claimed
- 1999-2005: $821.6M investments received

To aid in diversifying the Hawaiian economy, the legislature began passing economic incentive acts in 1999 and 2000 that would help in attracting such high technology businesses. The Tax Director at the time, Ray Kamikawa, helped take the lead in the state's goal to foster the growth of knowledge-based industries. One component of Acts 178 (1999) and 297 (2000) was a modest nonrefundable tax credit for investments in qualified high technology businesses (10%), not to exceed $500,000 in credits per company. Qualified companies included mostly R&D, computer software development, performing arts production, and biotechnology, all with minimum percentages of work and service done in Hawaii. Not only were individuals allowed to take advantage of this opportunity, but banks and insurance companies could also be investors, applying the credit against franchise and insurance premium taxes.

Soon after these measures took effect, Mr. Kamikawa became convinced that the 10% credit was not enough. After considering the case made by the Hawaii Science and Technology Council, he believed that substantial investing in qualified high technology businesses (QHTBs) would be the best way to leverage capital for real growth. Once he stepped down from public office, he lobbied for a bolder tax credit, in order to attract the attention of technology companies and investors worldwide. Also, the Tax Department had experienced that the low income housing credit was instrumental in getting low income housing off the ground. Therefore, if a tax credit helped to create necessary low-income housing, could a tax credit not also attract investors from all over? So, in May 2001, with the support of Governor Benjamin Cayetano, the legislature passed Act 221, which included the 100% tax credit for investments in QHTBs.

Act 221 dramatically extended the reach of Hawaii's efforts to grow knowledge-based industries. First, Act 221 allowed more sub-industries to qualify: sensor and optics technology, ocean sciences technology, non-fossil fuel energy technology, astronomy, and an expansion of performing arts productions. It is noteworthy that some of these new inclusions were introduced by neighboring islands and others came from members of the legislature. Second, Act 221 also allowed investors to transfer credits from one out-of-state investor to an in-state investor. If the investors are set up within the same entity, such as a partnership or an LLC, then there is an allowance to claim up to 200% credit per investment for the Hawaiian investor. The non-Hawaiian investor would then receive a greater share of equity in return for the transferred credit. For example, if a Hawaiian investor and a Californian investor form a partnership to invest in a Hawaii-based optics-technology start-up, only the Hawaiian investor can benefit from the tax credit. As such, the Californian investor would not have any benefit. In order to attract the Californian investor, Hawaii allows the Hawaiian investor to claim the Californian investor's tax credit on a 2-to-1 (200%) basis. Since the California investor is transferring his or her credit to the Hawaiian investor, the Californian investor would receive a greater percentage of equity in the business as compensation. This encourages Hawaiian investors to partner up with investors from anywhere.

The tax credit is administered completely through the Department of Taxation. The way it currently works is that entrepreneurs self-assess their projects and submit the application to the department. Potential investors then contact the department and request "comfort letters," which state that, as far as the department is aware, a business plan qualifies or does not qualify for the credit. While this communication practice provides clarity on what businesses quality as QHTBs most of the time, there are businesses that believe they qualify when in fact they do not. According to the current Department of Taxation Rules Officer, Johnnel Nakamura, one area in which they have had problems is with software service companies that do not qualify. To count, a business must be in software *technology*, not simply provide service for software.

To monitor the effectiveness through collecting metrics on Act 221, the Department of Taxation is in the process of improving the system that was originally set in place. In the past, the department had a form that the businesses should complete about themselves (form N-317). Much like the qualification, the data collected was essentially the representation of management. Just recently, the legislature passed Act 206 that now requires the Department of Taxation to study the high-tech tax credit. There is a new form (though still labeled N-317) and companies are required to complete it electronically.

The old form was updated and many questions have been added. More data is requested regarding jobs, and more details are requested regarding revenues and expenses. Also, there are more specific categories within the principal business categories, which are the same categories used by the Hawaii Science and Technology Council to study industries. This new stipulation applies to all companies whose investors received the credit beginning in June 30, 2003. Starting in July 2008, if the companies fail to complete the form, they suffer a $1,000 penalty per month until the end of 2008. The primary reason for this requirement of extra data is because the tax credit set to expire on December 31, 2010, and it is more likely to be extended again if there is convincing data to support it.

In some respects, the tax credit is difficult to manage. First, the survey collects data on companies, but it is the investors who receive the tax credit. Second, the tax department also has to investigate when investors claim more credits than they have been granted. The department must ascertain that there is indeed business purpose and economic substance for the potential 2-to-1 transfer claim reserved for the in-state investors in the special-purpose entities described earlier. Given that 157 QHTBs filed in 2006, this could amount to a significant level of investigation. To clarify any difficulty with understanding the credit, the department has recently analyzed all the company data that it had previously gathered on Hawaii's investment credits.

In October 2007, the department published a full, highly detailed report on the history and data of the program since its genesis in 1999. From 1999 to 2005, this report states that the tax credits claimed totaled $195.6 million, while investments received by the QHTBs totaled $821.6 million. The performing arts sector received roughly 35% of all investment dollars received, but computer software technology was the most frequently listed activity. This authoritative report can be found on the tax department's website.

As the maximum is 100% (with a possibility of 200% for some), virtually all risk is eliminated for the investor. However, because the credit is applied over the span of five years, there is a loss of value in the time value of money. According to prior studies, this elimination of risk is not necessarily the best practice. Perhaps the data in the October 2007 report tells a different story. Essentially, Hawaii is a unique state, and this bold state incentive takes into account Hawaii's remoteness and singularity.

## Kansas' Whirlwind

Being a perennial symbol of the heartland, Kansas is generally seen as a "flyover state." Like many states in Middle America, Kansas is not necessarily thought of as a leader or a dominant economic force. However, as the twentieth century gave way to the twenty-first, Kansas' leaders were helping to shape Kansas as a symbol of another American ideal: technological innovation. Through the leadership of the Kansas Technology Enterprise Corporation (KTEC), Kansas is increasingly a home for promoting technology-based economic development, particularly in biotechnology.

KTEC is a state-established organization that is a public/private entity, which affords it a certain flexibility. According to Michele Weigand of KTEC, it maintains an independent board, as it has for twenty years, and does not report to the Department of Commerce. As a private entity, KTEC directs its energies toward all high technology start-ups, which allows it to cross many boundaries. It is able to partner with four universities and the two major angel networks in Kansas. As a public entity, KTEC receives funding from the state lottery and has a responsibility to approve businesses and investors for the Kansas Angel Investor Tax Act passed in 2004.

**Kansas**

- original $2M annual cap; now $6M annual cap
- administered by KTEC
- all angel networks share diligence
- 2005-2007: $6.6M credits claimed
- 2005-2007: $81.3M capital raised

The Angel Investor Tax Credit began in January of 2005. In just the first forty-five days of the tax credit, the state awarded the entire $2 million appropriated by the legislature. After this whirlwind of activity, KTEC soon realized that it would need to adjust the process for approving companies and perhaps raise the credit limit, but any changes would not take place until 2006. Ms. Weigand, who joined KTEC in 2005 and is currently responsible for coordinating the angel community and managing the tax credit program, has witnessed evolution of the program's progress.

The program's processes have evolved so that instead of entrepreneurial projects simply meeting structural criteria to qualify, the government has given KTEC the authority to evaluate projects on a more rigorous and detailed basis.  Today, KTEC examines the business plan and financials, scores the deals, and then reserves tax credits, following a two-week evaluation cycle.  Like other many other state angel tax credits, it is targeted to high-growth, high-technological business plans.  The annual credit limit has also been raised twice since the 2005 debut, finally rising to a total of $6 million for 2008, which is projected to stay constant until 2016.  One other change that took effect was that investors can carry the credit forward indefinitely.

Kansas places a priority on gathering metrics on its qualified companies, so it can properly evaluate the effects of the tax credit.  As such, KTEC is required to measure the companies based on jobs created, revenue, and all capital that has been raised.  Since 2005, entrepreneurial projects have raised twelve times the capital that was granted in tax credits.  From 2005-2007, Kansas granted $6.6 million in tax credits, and the start-ups have raised $81.3 million in capital.

A potential strength of Kansas' program is that it works in conjunction with all of the angel organizations in the state.  The angel groups share due diligence with the others, sending deals back and forth across the state.  Not only does this help KTEC know what deals are being presented, it is easier for the entrepreneur to access capital and to communicate with more potentially interested parties.  In this respect, angel networks are not competing with each other for projects, and it does not matter who talked to the entrepreneur first, because eventually he or she will be referred to everybody.  Plus, due diligence only has to be done once.  KTEC believes that this system of communication and transparency is a big part of why companies are able to raise capital in Kansas.

## Wisconsin's Growth

At the beginning of the twenty-first century, Wisconsin watched the tech bubble inflate and deflate.  During this time, organizations and journalists were promoting the idea of venture investments, but it had yet to take root on a legislative level.  Though Wisconsin had experienced success in more traditional areas of manufacturing and agriculture, there was a general sense that Wisconsin had, in the wake of the rise of technology, somehow missed a huge opportunity for growth.  Also, in the early years of the 2000s, there was the sense that Wisconsin was in a rough economic situation, and by 2003, Wisconsin was looking at a $3.2 billion budget deficit. According to the current Deputy Secretary of Commerce, Aaron Olver, the buzz about venture and angel capital spread throughout the ranks of key legislators, officials, and economic policy advisers about focusing on seed stage investment as a way to economic development.

When Governor Jim Doyle took office in 2003, he focused on an economic development plan under the banner "Grow Wisconsin." The administration was challenged to think creatively about economic stimulus packages, but again, it was a difficult time to introduce an investment tax credit. In attempting to balance the budget, Wisconsin did not have the latitude to commit huge dollars, so the Secretary of Commerce, the Governor, and the legislative leadership agreed to $3 million annual limit in angel tax credits, based on a 25% credit of the individual investment made. The Governor, the private sector, and the legislative branch ultimately agreed to 25%, after rejecting an initial proposal of 40%. Through currently the 25% credit is split over two years, there are efforts to change the law so that all of the credits are recognized in the first year. As with most investment incentive programs, Act 255 targets businesses that are in the high-growth, high-tech and bioscience fields.

The structure of the program is very clear in delineating the responsibilities of both the state and the private sector. There are two major organizations involved in the program—one public, one private—but the two organizations exist independent of one another. The public entity is the Department of Commerce, which approves the businesses that qualify for the tax credit and administers the tax credit to the investors. The private entity is the Wisconsin Angel Network (WAN), under the Wisconsin Technology Council, a non-profit entity which is not a part of the government. The Wisconsin Angel Network's mission is to provide educational opportunities for angel investors, to enhance the deal-flow pipeline, to aid in forming angel networks, to measure results, to communicate, and to provide any other support in the service of angel networks. WAN does not have money of its own to invest; rather, it focuses on arranging conferences and networking opportunities on many levels. The program is designed so that the public and private sectors work in harmony.

**Wisconsin**

- spirit of Gov. Doyle's 2003 growth initiative
- administered by Dept. of Commerce
- WTC and WAN educate, communicate
- 2005: $66.6M early-stage investing
- 2006: $102.9M early-stage investing

Wisconsin appears to have a thorough process of ushering in high-technology development. According to Mr. Olver, an entrepreneur first comes to the Department of Commerce to sign the application in order to obtain approval and certification. The first process is public. After successful certification, the entrepreneur can upload a business plan to WAN. This second process is private, and the most logical place to get information about private investors is the Wisconsin Angel Network. The two founders of the WAN were Secretary Lorrie Keating Heinemann of the Department of Financial Institutions and Tom Still of the Wisconsin Technology Council. Their prime concerns were in establishing strong communication and connections has helped entrepreneurs and angels find their way to each other. Ms. Keating Heinemann emphasizes that angel investing is primarily based on personal relationships. As such, WAN and its director, Joe Kremer, offer just one way for entrepreneurs to make angel contacts.

Communication and connections are critical for success. One important aspect of the initial success of WAN and Act 255 was media coverage. Mr. Still used his prior experience and training as a journalist to promote the program through his statewide board and through the press. The Wisconsin Technology Council became a nationwide link to the activities in Wisconsin. Positive press helped create a positive angel investing environment—one that promotes the idea of risk-takers. WAN began building relationships, communicating, and educating in 2004, even before the credit had begun. Ms. Keating-Heinemann invited a national leader in angel investing to speak about angel investing in four key communities. As a result, four new angel networks formed. Ms. Keating-Heinemann credits this initial success in that WAN invited the right people to be at these meetings who were interested in helping their local economies. The next year, in 2005, WAN held four "Power of Angel Investing" seminars developed by the Ewing Marion Kauffman Foundation. Today WAN still holds conferences that offer such workshops, continuing these important communications.

The metrics used to evaluate the performance on the tax credit come from three principal avenues. As Daniel Sandler cautioned, it is difficult to gather information on the performance of the tax credit, so Wisconsin has taken a multi-faceted approach to its metrics. Primarily, the data come from the Department of Commerce. In addition to these, WAN regularly surveys attorneys, CPAs, and angel groups. When it comes to evaluating how many jobs were created, it was difficult for WAN to know if it had accurate data and to know about ongoing projects that did not necessarily qualify for Act 255. To help with this problem, WAN used NorthStar Economics, based in Madison, Wisconsin to investigate and cross-reference the data to ensure there was no overlap.

The Wisconsin process is clear and streamlined, but more importantly, it is visible. Ms. Keating Heinemann shared a story that indicates a new trend in Wisconsin angel investing. At the November 2007 Early Stage Conference, put on by the Wisconsin Technology Council, there were angel group members actually passing out their business cards to people. This shows a radical departure in the previous approach to angel investing, and some angels are actively pursuing investments and attending conferences. WAN credits David Ward of NorthStar Economics, who specifically recommended that the risk capital be "visible capital" and that there should be one visible person that an entrepreneur can easily find. Hence, visibility, communication, connection-building are central pillars of Wisconsin's way of growing its high-technology economy.

*Editor's Note: Ms. Keating Heinemann reported in June, 2008 that angel investments had grown by 43 percent over a year ago in Wisconsin. The state has documented angel investments of $147 million in the last year.*

## Kentucky's Plan

At the turn of the twenty-first century, the Kentucky's legislature enacted statute §154.20-250 to -284 with the intent to give investment preference to Kentucky small businesses showing potential for rapid growth. Labeled the Kentucky Investment Fund Act (KIFA), it is the oldest of any state program that is examined in this paper, passed in 1998.

The Kentucky Investment Fund Act is different from the programs of Hawaii, Kansas, and Wisconsin in the fact that it requires the formation of an approved seed or venture capital fund before granting credits to individuals or legal entities they invest through that would have state tax liability, including financial institutions and insurance companies. This means that KIFA is a hybrid program that combines potential tax credits for individual accredited investors with a seed/venture capital program that could also provide credits to institutional investors. Data on the portion of credits that go to individuals versus institutional investors is not available.

According to the Kentucky Economic Development Finance Authority, the minimum fund size is $500,000, the fund must have no less than four unaffiliated investors, and no investor can have more than a 40% interest in the fund. The total amount of tax credits that can be awarded over the lifetime of any one fund is $8 million, and the entire KIFA program has a maximum lifetime ceiling of $40 million. Once this total $40 million is gone, it will require legislative action to provide any additional funding to KIFA. Donna Duncan, the Commissioner of Financial Incentives, says these ceilings have not posed any problem. It is important to note that each single fund must invest in enough ventures so that the total qualified investments made in any single business shall not exceed 30% of the committed cash contributions to the investment fund. Therefore, any investments made must be 1) made with others contributing relatively comparable amounts of capital, and 2) in multiple venture projects, properly limited so no venture is more than 3/10 of all pooled money in the fund.

**KENTUCKY**

- ✓ credit for funds comprised of >4 investors
- ✓ administered by KEDFA
- ✓ state must approve fund manager
- ✓ no investor with >40% capitalized interest
- ✓ no fund with >30% invested in any one business

Each fund must have an approved professional manager, with approvals based on the strength of the manager's credentials. The fund manager must have "relevant experience and demonstrated ability to manage the proposed investment fund," according to statute §154.20-256. No credit will be allowed before the manager and the fund itself comply with any and all applicable laws. As an added bonus, the Department of Revenue has the authority to establish additional procedures and standards, as it deems necessary for the approval of investment funds and investment fund managers. The state is keeping a close eye on its program, to prevent abuse.

There are limitations on the kinds of companies that qualify for investment, both in minimum percentages of business done in Kentucky as well as the nature of the business activities. The "qualified activities" include any industrial, manufacturing, mining, mining reclamation, commercial, health care, agricultural enterprise, or agribusiness activity. The law specifically disallows a number of other lifestyle industries, such as financial services, insurance, or residential housing development. The law states that Kentucky is "giving preference to its small businesses that show a potential for rapid growth." However, this seems a fairly open definition of the high-growth sector, especially when most all other states would not consider manufacturing or mining to be a qualified activity.

If all criteria are met, an investor stands to benefit from the investment. A 40% nonrefundable credit can be applied against individual income tax, limited liability entity taxes, corporation license taxes, insurance taxes, as well as taxes on financial institutions, though not unconditionally. If a credit is granted, then an investor can only claim half of the granted credit in any one tax year, subject to a fifteen-year carryover period. Normally, credits are not transferred, but naturally, there are exceptions to the rule.

The Kentucky system represents a public/private collaboration. To keep things clear, KIFA is the backbone of the Kentucky investment incentive. But, there is also the Commonwealth Seed Capital Fund (CSC), which is a state fund that invests state money into ventures. Although the CSC fund is a state-funded entity, chaired by the Commissioner of the Department of Commercialization and Innovation, its administration is outsourced to a private business. According to George Emont of the Kentucky Seed Capital Fund (KSCF), a private fund begun in 2005, the CSC's investment committee is made up of business people from around the state.

Louisville and Lexington are the primary locations for any investing, boosted by the presence of their respective state research universities, the University of Louisville and the University of Kentucky. For example, last July, Alltranz, Inc. was a biotech business started by a University of Kentucky researcher who received funding from the private Kentucky Seed Capital Fund (KSCF), in addition to three other Kentucky angel/venture funds. But, investors in the KSCF included the Commonwealth of Kentucky through the state's CSC fund, among other private foundations and health care corporations from Louisville and Lexington.

## Conclusions and Considerations

The purpose of this paper is to investigate four representative state angel tax credit programs, and it presents how Hawaii, Kansas, Wisconsin, and Kentucky are managing their credits and incentives for angel investing. Again, this is not meant to be a comparative study of four states' angel tax credit programs. Rather, this paper presents the four programs alongside each other and then identifies some traits, goals, and practices that should inform other state policy makers who are considering state angel incentive programs.

One common theme in all of the sample states, there is some kind of science and technology body working to promote the investments. Hawaii has its Science and Technology Council, which serves as communicator and cheerleader for Hawaii's Act 221, but there is no formal relationship between it and the state. Kansas' state-sponsored public/private KTEC takes a central role in developing the incubators across the state in both universities and angel organizations. Wisconsin's Technology Council is the umbrella organization for WAN, and Technology Council members are highly involved in the mission and operation of WAN. Kentucky has a Department of Commercialization and Innovation that actively invests state dollars into technology companies. The nature of the science and technology bodies clearly varies, but its encouraging presence is undeniable.

Research universities also seem to play a role in angel efforts, even if there is no formal relationship with the state. Because Hawaii's Act 221 is completely state-run, there are no formal ties to the University of Hawaii. However, the leader and founder of the Hawaii Angels is Dr. Robert Robinson, a professor at UH-Mânoa, who is active in the Hawaii Science and Technology Council. Kansas's KTEC has incubators at Kansas University, Kansas State, Wichita State, and Pittsburg State. While Wisconsin's Department of Commerce does not have formal connections with its major research institution, the University of Wisconsin-Madison, Deputy Secretary Olver claims that much activity comes from it. Within UW-Madison, Commerce has worked with the Wisconsin Alumni Research Foundation (WARF) which is a patenting operation. From the example in Kentucky, the angel community looks to its major universities as a generator of ideas. Whether formal or not, the presence of major universities seems to be key in all four states.

Those who say, "It's not *what* you know, it's *who* you know," are only partly correct. In today's demanding economy, it is both *who* and *what* you know. The NASVF report states clearly that "the greater the opportunity to build these relationships, the greater the chance that understanding and trust can develop, and that money can flow to worthwhile ventures." From this study, it seems that Kansas and Wisconsin have put a particularly keen emphasis on creating these kinds of relationships. And it seems that there has been more energy created because of this. It certainly seems like these kinds of activities get more people thinking, seeing, and hearing about angel investments. Thinking, seeing, and hearing are the hallmarks of creating a culture; in this case, it is a culture of getting economically viable high-growth projects off the ground. Any state that is truly interested in promoting this kind of growth would do well to actively work on building new and meaningful relationships among the right people.

A state legislature can pass a law providing a tax incentive for angel investing, but it is not the law alone that can account for any of its success. Consider the case of Vermont. According to Cairn Cross of FreshTracks Capital in Vermont, the Vermont Seed Capital Fund was never started; and therefore, the credits have not been used. This is probably attributable to a combination of reasons: there was no champion of the program, it was not widely publicized, and its 10% credit was not particularly generous. So, even though a state can construct a properly targeted angel investment credit program, the best practice that the state can put forth is one where building relationships and communication among entrepreneurs and angels can thrive.

## Appendix A
## List of States with an Angel Tax Credit Program

The National Governors Association's recent report delineated 18 states that had an angel investment tax credits (Appendix F of the report), and it also described two other states that had similar programs. Here are the states presented in the NGA report.

| *state* | *name of tax credit (TC)* | *rate* |
|---|---|---|
| Arizona | Angel Investment TC | 30% |
| Hawaii | High Tech Investment TC | 100% |
| Indiana | VC Investment TC | 20% |
| Iowa | QB Investment TC | 20% |
| Kansas | Angel Investor TC | 50% |
| Louisiana | Angel Investor TC | 50% |
| Maine | Seed Capital TC | 40% |
| New Jersey | High Tech Investment TC | 10% |
| New Mexico | Angel Investment Credit | 25% |
| North Carolina | QB Investment TC | 25% |
| North Dakota | Seed Capital Investment TC | 45% |
| Ohio | Tech Investment TC | 25% |
| Oklahoma | Small Business Capital Credit | 20% |
| Oregon | University VC Funds | 60% |
| Vermont** | Seed Capital Fund | 10% |
| Virginia | QB Investment Credit | 50% |
| West Virginia | High Growth Business Investment TC | 50% |
| Wisconsin | Angel Investor TC | 25% |
| Kentucky* | Kentucky Investment Fund Act | 40% |
| Michigan* | Angel Investor Incentive | N/A |

*Kentucky and Michigan were described in the report, but not listed as an angel tax credit in the NGA Appendix F. This is most likely because Kentucky's tax credit does not apply to a single investor; rather it applies to a fund of multiple investors investing in multiple companies. Michigan does not offer angels an income tax credit; rather, it offers a deduction from capital gains income as an incentive for angel investing.

**According to the research of this paper, Vermont's 10% Seed Fund tax credit, though still on the books, is in fact nonexistent. Instead, Vermont currently has an Angel Venture Investment Capital Gain Deferral Credit that provides an up to 60% deferral of capital gains on investments of up to $200,000. This paper did not investigate all states, and other states have since created new programs and eliminated others, such as the Iowa program.

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