Investment Tax Credit Alert

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Accelerate Wisconsin: New Laws Expand Wisconsin's Investment Tax Credit Program for Early Stage Businesses

To encourage high-growth and high-tech business in Wisconsin, the state provides tax credits for certain investments in early stage business ventures. Recently enacted laws and new administrative rules expand the program by increasing the maximum tax credits available and make the tax credits more flexible.

Program Overview

- **Tax Benefits.** The Wisconsin Department of Commerce (the "Department") oversees the tax credit program, which is part of the Accelerate Wisconsin initiative and includes two types of tax credits: the Angel Credit and the Early Stage Seed Credit. The Angel Credit may be used to offset Wisconsin individual income taxes, while the Early Stage Seed Credit may be used to offset Wisconsin individual, franchise, and corporate income taxes. The credit is equal to 25% of the qualifying investment. Unused tax credits may be carried forward for 15 years. To the extent a credit is used to offset Wisconsin taxes, the taxpayer must correspondingly reduce the investment's basis for Wisconsin purposes.

- **Qualifying Businesses.** Tax credits are potentially available for investors investing in "Qualified New Business Ventures" that are certified by the Department.

- **Angel Credit.** The Angel Credit is potentially available to accredited investors making qualified investments in Qualified New Business Ventures either directly or through a single purpose entity.

  Angel Credit: Credit for an individual investor with a direct investment.
  Angel networking groups have to choose between forming a single purpose entity, investing through a venture fund, or making individual investments.

- **Early Stage Seed Credit (Venture Funds).** The Early Stage Seed Credit is potentially available to investors making qualified investments in a Qualified New Business Venture through a fund certified by the Department.

  Early Stage Seed Credit: Credit for an Investor Investing Through a Venture Fund.
  When certifying funds, the Department reviews the fund manager's experience, past performance, and the fund's commitment to investing in Wisconsin, among other factors.

  Action Item: Businesses must go through the Department's certification process before any investments are made, otherwise early investors will be ineligible to receive tax credits, even if they make follow-on investments *after* the business is certified as a Qualified New Business Venture. For this reason, investors should avoid making cash capital contributions to a business anticipating certification as a Qualified New Business Venture, such as by instead loaning funds, although the Department has informally indicated that there may be a *de minimis* exception for small capital contributions.

New Rules, New Requirements, Increased Credits

The Department's new administrative rules (scheduled for publication June 1, 2010) implement many changes made by 2009 Wisconsin Act 2 (the "Budget Bill"). The Budget Bill and the changes made by the newly enacted 2009 Wisconsin Act 265 ("Act 265") are favorable for Wisconsin businesses and taxpayers.

- **Million Dollar Increase in Tax Credits Available for Investments in a Qualified New Business Venture.** Effective for tax years beginning in 2011, the Budget Bill doubled the amount of tax credits each Qualified New Business Venture can receive, from $1 million to $2 million.

  Action Item: Qualified New Business Ventures that have already reached the maximum credit amounts should consider contacting the Department to increase their eligibility for tax credits in 2011.

- **Increased Total Amounts for Allocation.** The Budget Bill, along with Act 265, increased the annual aggregate amount of Angel Tax Credits available to all investors to $6.5 million in 2010 (up from $5.5 million) and to $20 million per year in 2011 and beyond. For the Early Stage Seed Credit, the annual aggregate credits increased to $8 million in 2010 (up from $6 million) and to $20.5 million per year in 2011 and beyond.[1] Beginning in 2011, an additional $250,000 in separate tax credits will be annually available for nanotechnology businesses.

  Action Item: To ensure credit allocations, businesses should be certified as soon as possible and should submit a request for tax credits as soon as investments are made. The Department typically allocates credits on a first-come, first-served basis. Although all the tax credits available have not yet been used in any year since the program's inception, if the demand for credits exceeds the total allocable amounts available, the Department may reserve tax credits from the following year's allocation or deny the request for the credit that exceeds that year's allocation. If the Department reserves the tax credit from the following year's allotment, the benefit of the credit will not be available until the following year.

- **Tax Credit Transfers.** The new rules permit the Early Stage Seed Investment credit to be transferred. This allows fund investors without Wisconsin tax liability to monetize their credits. For transferred credits, the Department is entitled to charge a 1% fee. (Angel Credits can not be transferred.)

  Action Item: Fund managers should consider an indemnification requirement for any credit transfers done by fund investors, as the fund is responsible for repaying any transferred credits that are later revoked. The parties involved in the credit transfer should also negotiate a fair purchase price in light of the transfer fee. Finally, while Wisconsin law permits special allocations of the Early Stage Seed Investment credits within funds via the entity's governing documents,[2] the Department has informally indicated it will not respect special allocations unless the transfer fee is paid.

- **Updated Qualification Criteria for Qualified New Business Ventures.**

  o *Business Criteria.* The Budget Bill updated the types of business activities that meet certification criteria. The new rules require Qualified New Business Ventures to have the potential for (1) increasing Wisconsin jobs or (2) increasing capital investment in Wisconsin (or both), and (3) must also engage in innovation in one of the following areas:
    - SPECIFIED INDUSTRIES. Biotechnology, Nanotechnology, Communications, Agriculture, Clean Energy, or Manufacturing;
    - PRODUCT PROCESSING/ASSEMBLY. Product processing or assembly, including medical devices, pharmaceuticals, computer software, computer hardware, semiconductors, other innovative technology products, or products that are produced using manufacturing methods that are enabled by applying proprietary technology; OR
    - PROPRIETARY TECHNOLOGY. Pre-commercialization activity related to proprietary technology, including conducting research, new product development, development of a new business process, or developing services applying proprietary technology.

  Action Item: : Businesses that did not qualify under the pre-Budget Bill criteria should consider whether they are newly eligible under the updated qualification criteria outlined above. In certifying businesses, the Department will continue to consider (1) whether the business is in one of Wisconsin's targeted industries (as determined by the Department), (2) the high growth potential of the business, (3) management team experience, (4) financial need, (5) percentage of funds that will be spent in Wisconsin, (6) barriers to entry, and (7) involvement in an innovative or novel product or process.

  o *Out of State Fund Managers.* For out-of-state venture funds, the new rules require the investment to be made coincident with Wisconsin-based investors. The ratio of required coincident in-state investment will depend upon the fund manager's demonstrated experience, performance and focus on the Wisconsin region, as determined by the Department. This newly added requirement is intended to prevent abuse of the tax credit program, as out-of-state investors are now able to transfer Early Stage Seed Credits to individuals with Wisconsin tax liability.

  o *Headquarters.* Qualified New Business Ventures were always required to have Wisconsin headquarters, but the new rules now define "headquarters" as "the commercial business location where staff members or employees are physically employed and where at least 51% of the company's financial personnel, legal, planning, or other headquarters functions are handled." Accordingly, a Qualified New Business Venture must do more than merely incorporate in Wisconsin and must maintain most of its administration in Wisconsin.

  o *Qualified New Business Ventures That Outgrow Certain Qualification Criteria May Remain Eligible For Credits.* Under the new rules, the Department will only apply the following Qualified New Business Venture certification criteria at initial certification: employment (max 100 full-time equivalent employees), longevity (max 10 years in operation) and investment thresholds (max $10 million in private equity investment). In other words, so long as a business continues to meet the Qualified New Business Venture certification criteria (Wisconsin headquarters, most employees employed in Wisconsin, etc.), the business can outgrow some of the initial certification criteria and still remain certified as a Qualified New Business Venture.

[1] The Department's new rules only reflect changes made by the Budget Bill, which increased the allocable credits to $18 million (Angel Tax Credits, effective 2011) and $18.5 million (Early Stage Seed Credits, effective 2011) (the Budget Bill, unlike Act 265, did not include increases for 2010 allocable amounts).

[2] Wis. Stat. 71.07(5b)(b)2. permits special allocations of the credit in the organizing documents of an LLC, S corporation, or partnership.

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- **Businesses Relocating to Wisconsin.** Under Act 265, the Angel Credit can be claimed for investments made in a business located outside of Wisconsin if the investment is made no earlier than 60 days before the business is relocated to Wisconsin *and* the business is certified as a Qualified New Business Venture within 180 days after relocating to Wisconsin.

Coming up in 2011: Capital Gain Rollovers into "Qualified New Business Ventures"

- **Summary.** Effective 2011, investors may exclude up to $10 million in long-term capital gain from Wisconsin taxable income if the gain is reinvested into a "Qualified New Business Venture." However, "Capital Gain Qualified New Business Ventures" are defined differently in the law from Qualified New Business Ventures for the purposes of the Angel Credits/Early Stage Seed Credits. Although the Department has not yet created rules for certifying businesses for the capital gain benefit, the statute defines Capital Gain Qualified New Business Ventures as businesses that are (1) developing a new product or business process, or (2) involved in manufacturing, agriculture, or processing or assembling products *and* conducting research and development. Potentially a business could qualify as (1) a Qualified New Business Venture, (2) a Capital Gain Qualified New Business Venture, or (3) both.

  Action Item: Until the Department promulgates rules for certifying Capital Gain Qualified New Business Ventures, investors should not assume that a Qualified New Business Venture for the Angel Credit/Early Stage Seed Credit will automatically be certified as a Capital Gain Qualified New Business Venture.

- **Process for Capital Gain Rollovers.** To take advantage of the gain rollover provision, investors will need to:
  i. deposit all or a portion of the long-term capital gain from the sale of a capital asset into a segregated account in a financial institution,
  ii. within 180 days of the disposition giving rise to the gain, reinvest all of the gain held in the segregated account into a Capital Gain Qualified New Business Venture, and
  iii. file a disclosure with the investor's Wisconsin tax return.

A required basis adjustment ensures that the capital gain is eventually taxed.

Action Item: Under the current requirements, taxpayers will need to pay strict attention to the detailed requirements to make an eligible gain rollover. "Any amount" of long-term capital gain can be excluded, which means taxpayers can deposit only a portion of a long-term capital gain into a segregated account – *but* once this portion is deposited, the statute requires *all* of the gain held in the account to be invested into a *single* Capital Gain Qualified New Business Venture. To provide flexibility, taxpayers may need to set up multiple segregated accounts which could then be used to invest in multiple Capital Gain Qualified New Business Ventures (or permit the investor to extract some of capital gain and pay tax on it). Alternatively, investors should finalize their reinvestment decisions before triggering the long-term capital gain, which would permit the exact rollover amounts to be set aside in segregated financial accounts.

Godfrey & Kahn attorneys are familiar with all stages of applying for and claiming the Angel Credits and Early Stage Seed Credits and qualifying your business as a Qualified New Business Venture. To learn more about these credits or how we can assist your early stage business, please contact any member of the Godfrey & Kahn tax or corporate teams, including:

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