DEPARTMENT OF AUDITS AND ACCOUNTS

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Honorable Dar'shun Kendrick
State Representative
404-F Coverdell Legislative Office Building
Atlanta, Georgia 30334

SUBJECT: Fiscal Note
House Bill (LC 44 1539)
House Bill (LC 44 1540)

Dear Representative Kendrick:

The two bills would renew the qualified investment tax credit under O.C.G.A. §48-7-40.30, which expired for new investments as of December 31, 2018. Both bills would make credits under this section available for investments made in calendar years 2020-23, but with modifications.

Both bills would make the credit, calculated at 35 percent of the qualifying investment (as defined), available to investors in "an entrepreneurship program, center, or initiative of a postsecondary educational institution established prior to 1964, whose principal mission was, and is, the education of black Americans" (hereafter referred to as an HBCU entrepreneurship program). Both would also permit an investment that involves a broker fee or commission (not previously eligible), but the fee or commission amount is excluded from the qualified investment amount.

The bills differ only in that credits under LC 44 1540 would be limited to only those investments made in an HBCU entrepreneurship program, while LC 44 1539 would also allow credits for investments in businesses that would have qualified under existing law prior to the credit's expiration. Under both bills, the individual credit limit is $50,000 in a single year and the total annual cap is $5 million. Other conditions and limitations are outlined in the attached appendix.

Georgia State University's Fiscal Research Center (FRC) provided a range of estimated impacts on state revenue for the two bills. As shown in **Table 1** on the following page, neither bill has an immediate impact because of the required delay between investment and claiming of the credit. LC 1539 would reduce state revenue by $1.3 million to $4.8 million in fiscal year 2025, while LC 1540 has a range of $0 to $4.8 million in revenue reductions. The lower estimates for both bills assume no increase in credits due to the bills' provisions related to brokered transactions and HBCU entrepreneurship program investments. LC 1539's lower estimate is $1.3 million because the bill continues currently permitted credits for which there is better data to estimate future investment. Details of the assumptions made for each are also provided in the appendix.

Table 1. Estimated State Revenue Loss from LC 44 1539 and LC 44 1540

($ *millions*)	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025
LC 44 1539:					
Upper Bound	-	-	-	$4.0	$4.8
Lower Bound	-	-	$0.8	$1.1	$1.3
LC 44 1540:					
Upper Bound	-	-	-	$4.0	$4.8
Lower Bound	-	-	-	-	-

Impact on State Expenditures

The bill would require the Department of Revenue to modify two information systems. The agency estimated one-time costs of approximately $198,000 for personnel and no additional on-going costs.

Sincerely,

Greg S. Griffin
State Auditor

Kelly Farr

Kelly Farr, Director
Office of Planning and Budget

GSG/KF/mt

Analysis by the Fiscal Research Center

Background on the Angel Investor Credit

The income tax credit available under O.C.G.A. §48-7-40.30, often referred to as the qualified investment tax credit or the angel investment tax credit, was available for qualifying investments made in tax years 2011-18. Key terms and conditions of the credit were as follows:

- Credits may be taken in the second taxable year following the year of investment (e.g. in 2020 for 2018 investments) at a rate of 35 percent of the amount of qualifying investments, subject to a maximum credit amount of $50,000 per year per qualified investor.
- Qualified investors include 1) individual persons who are residents or non-resident taxpayers of Georgia, or 2) a pass-through entity "which is formed for investment purposes, has no business operations, has committed capital under management [no greater] than $5 million, and is not capitalized with funds raised …" from institutional investors. Hedge funds, or venture capital or commodity funds with institutional investors do not qualify.
- Qualified investments are cash investments in the common or preferred equity, or subordinated debt of a qualified business, defined, among other conditions, to include only businesses 1) organized less than three years before a qualifying investment is made, 2) having no more than 20 employees, 3) having had no more than $500,000 of revenue in any year, 4) having raised no more than $1 million to date in equity or debt, excluding bank loans, and 5) is primarily engaged in certain high-growth businesses, but not in specified service businesses. Businesses were also required to register and be certified by the revenue commissioner as a qualified business.
- The annual amount of aggregate credits available in any year was capped, most recently at $5 million per year. Investors are required to apply for the credit between September 1 and October 31 in the year in which they are first eligible to claim the credit. If eligible applications exceed the annual cap, amounts of credits approved were to be prorated among eligible applicants for that year.
- The credit is not refundable, but unutilized credits may be carried forward for up to three years after the year the credit is first claimed (five years from the end of the taxable year in which the qualified investment is made).
- Credits are subject to recapture if 1) the investor or an immediate relative becomes an active participant in the operation of the business, whether as an employee, contractor, or otherwise, providing services for compensation (not including stock, stock options or equivalent) within two years of the qualifying investment; or 2) the business redeems or repays any principal of qualifying equity or debt investments within five years.

Amounts of credits preapproved (for investments made two years prior) and amounts utilized on tax returns each year, 2014-19, are shown in Table 2 below, with the exception of amounts utilized for 2019, which are not yet available. The amounts of qualified investments made two years prior, implied by the preapproved amounts, are also shown.

Table 2. Tax Credits Preapproved and Utilized

($ *thousands*)	**CY 2014**	**CY 2015**	**CY 2016**	**CY 2017**	**CY 2018**	**CY 2019**
Preapproved	$694.5	$941.4	$889.7	$553.7	$557.7	$528.3
Implied Investment	1,984.3	2,689.7	2,542.0	1,582.0	1,593.4	1,509.4
Utilized	466.4	597.2	586.8	549.5	425.3	NA

Credits utilized in a tax year consist of some combination of new credits preapproved for that year and previously unused credits carried forward, though the share of each is not known. Over the last several years, total utilized credits have averaged just under 75 percent of the amount of credits preapproved. Note, however, that credits utilized, particularly for the most recent years shown, may be revised upward to the degree that returns claiming the credit have not yet been fully processed due to return extensions, audits, or amendments. Credit utilization reports from the Department of Revenue over recent years suggest upward revisions could push 2017 and 2018 utilization higher than the levels shown in the table.

Amounts preapproved peaked in 2015 at $941 thousand, based on investments made in calendar 2013. Since that time, the trend in preapprovals has been downward despite continuing strong growth nationally in seed-stage venture funding. Data from the Organization for Economic Cooperation and Development (OECD) show average annual growth in seed-stage investment in the US at about 18 percent over the three years ended 2019. A preliminary report from DOR on credit applications received to date during the current application window (Sept-Oct 2020) suggests that, if substantially all are approved, preapprovals for the 2020 tax year (2018 investments) would exceed $1 million.

Among the suggested reasons for the relatively small take-up of this credit, compared to the $5 million per year aggregate cap applicable since 2016, are 1) the administrative requirements for the business to register prior to accepting investments for which the investor expects to apply for a credit, 2) the two-year lag between investment year and being able to apply for the credit, and 3) the restrictions on investor participation in the business and on future financial decisions of the business to avoid violating recapture provisions in the law. A recent study from the Harvard Business School found that, in a survey of 2016-17 angel investors, the mean and median sizes of individual angel investments were about $35 thousand and $25 thousand, respectively. Given the $50 thousand per filer per year credit limit for the Georgia credit, implying a maximum individual qualified investment of nearly $143 thousand, this limit would not appear to be a major limiting factor in the take-up of the credit.

Proposed Changes and Likely Effects on Credit Take-Up

Brokered Investments: Both bill versions would allow investments the purchase of which involved payment of a broker fee or commission, which were previously not eligible, to be qualified investments, but only to the extent of the investment net of the fee or commission. This change would clearly provide an incentive for financial brokers or advisors to assist businesses in registering with the department and raising capital from qualified investors that might have otherwise not done so. However, while this would presumably increase take-up of the credit compared to recent levels, the size of the effect is highly uncertain.

A review of similar tax credit programs in other states revealed that South Carolina (SC) also precludes brokered investments from qualifying, while several others do not have such a restriction. However, there is no apparent relationship between the level of utilization of the credit and this restriction as SC reports reaching its $5 million cap regularly since 2017 while other states lacking the restriction do not, e.g. Arizona, Kentucky, and New Mexico. Thus, while the cost of this provision is expected to be positive, it cannot be estimated at this time.

HBCU Entrepreneurship Program Investments: Both bill versions also allow investments in HBCU entrepreneurship programs or centers to qualify for the tax credit, though LC 44 1540 would remove all other businesses qualified under current law from eligibility while LC 44 1539 would simply add this provision to the existing definition of qualified businesses.

Entrepreneurship programs or centers, sometimes described as start-up incubators, provide education, advisement and support, and sometimes work space and infrastructure for entrepreneurs and start-up businesses, and are often a part of, or affiliated with, colleges and universities (e.g. the Advanced Technology Development Center at Georgia Tech). Currently, at least 15 public and private HBCUs are part of the HBCU Innovation and Entrepreneurship Collaborative, including two in Georgia – Clark Atlanta and Morehouse – that currently operate entrepreneurship programs. However, the existing programs and centers all apparently operate as nonprofits serving educational, social, and economic development missions and none could be found that have also raised equity or subordinated debt capital from investors.

Also, no state investment tax credit programs could be found under which investments in such programs would qualify. Thus, no precedents exist on which to base estimates of take-up of the credit under this provision.

However, at least one private sector entity that collaborates with HBCUs on entrepreneurship programs reportedly has plans to raise sufficient financial capital in the near future that, if successful, could cause credits under either version of the bill to reach the $5 million annual cap for the first two years, at least.

Estimation Cases and Assumptions
Based on the foregoing, the estimates of state fiscal impact of the bills assume the following:

- The lower-bound case for both bill versions assumes no increase due to the two modifications discussed above to the definitions of qualified investments and businesses.
- Lower-bound projections for LC 44 1539 assume 2020 investments based on 2018 qualified investments (assuming applications received to date in the 2020 window are approved), growing in 2019 by -5 percent (based on OECD estimates for US seed capital investment) and flat for 2020. Beyond 2020, qualified investments are assumed to grow at 18 percent annually, the average growth rate over the latest three years as estimated by OECD.
- Lower-bound projections for LC 44 1540 assume zero qualifying investments because investments qualified under the prior law would no longer be eligible.

- Upper-bound projections for both bill versions assume sufficient qualifying investments in HBCU entrepreneurship programs beginning in tax year 2021 to reach the annual cap in preapproved credits. Note that, though the bills allow for qualified investments in calendar 2020, earliest possible enactment is in winter or spring of 2021. Thus, it is assumed that potential investors would defer until enactment is more certain and would not invest in 2020.
- In all cases, investments in a given year earn credits for the second tax/calendar year following the year of investment, and 80 percent of credits are utilized in the year first approved, with the balance carried forward. Also, in each year, 80 percent of the balance of credits carried forward from prior years will be utilized against that year's tax liability.
- Credits utilized in any tax year are assumed to impact state revenues in the fiscal year beginning July 1 of the given tax year.
- Note that any credits earned under existing law and carried forward into the projections period are costs of the existing law and thus are not included in the estimates for these bills.

Estimates based on these assumptions are presented in Table 1.