

STUDY ON
ANGEL INVESTOR PROGRAM

Kentucky Cabinet for Economic Development
Department of Commercialization and Innovation
Office of Research

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With Thanks To:

Finance and Administration Cabinet, Department of Revenue
Northern Kentucky Tri-County Economic Development Corporation

Introduction

The following information is gathered and presented at the direction of the General Assembly as set forth in HB 1 of the 2010 Extraordinary Session (Page 32). The Budget Bill directive states:

The Cabinet for Economic Development is directed to study the potential benefits of developing an Angel Investor Program, including an evaluation of the current Kentucky Investment Fund Act, the benefits of tax credits to encourage Angel investing, and the methods used by other states and the effectiveness of those methods. The Cabinet shall report to the Interim Joint Committee on Appropriations and Revenue by December 1, 2010.

Much interest has been generated in state income tax credits for individual investors in recent years. However, the general trend to seek effective stimulation for angel investment (also known as informal venture capital) has increased at the national and international levels as well.

The rationale for supporting the informal venture capital market emerged following publication of early empirical studies in Europe...by highlighting the scale of the market, its potential for expansion and the types of investments made by business angels. The investments were a precise match to those which were least attractive for venture capital to make. More importantly, these studies drew attention to the market's untapped potential. Not only were active investors unable to find enough investment opportunities, and so had substantial capital available for investment, but there also appeared to be significant scope for expanding the numbers of active investors.¹

This document addresses the following:

1. What are angel investors and why do we need them?
2. What incentives does Kentucky already have in place to encourage investment in start-up high-tech companies?
3. Is an individual investor tax credit necessary for Kentucky to remain competitive with other states in recruiting start-up businesses, high-tech industry, and needed funding?
4. Which of the current investment tax credit options is most likely to be beneficial to the Commonwealth?

All of these questions must be asked and answered in the context of achieving balance between a budget crisis limiting availability of state funding and the need to generate more economic activity that will produce jobs and revenues in future years. Like all tax credits, incentives for angel investors are in fact expenditures of state funds, and should be compared to other possible expenditures that could help accomplish the same goal.

What are angel investors and why do we need them?

The term “angel” refers to wealthy individuals (or groups of individuals) who provide entrepreneurs with capital, connections and guidance.² This seed-stage funding fills the gap between the initial investment in start-up businesses from family and friends and the venture capital type investment for business ventures that are more mature. Angel investors typically have investment portfolios in excess of \$250,000 in multiple companies. This type of investor also provides more for the entrepreneur than just funding.³

Individual or angel investors are different from venture capital investors and make investments that would not be made by the typical venture capital investor. Angels generally invest their own money into start-ups and early stage companies while venture capitalists are professional investors who pool money from institutions and individuals to support developed enterprises. The venture capital investors “have turned away from investing in start-up and early-stage businesses in favor of less-risky deals with larger, more mature companies”.

In 1995 38% of venture capital investment was in seed and early stage companies; by 2005 that figure had dropped to 19% according to the National Governors Association....Angel investors are increasingly filling the void left by the lack of investments being made by conventional lenders and venture capitalists.⁴

Evidence of this increased angel funding activity and its resiliency can be seen in the angel investor market in 2009, which on the heels of a considerable contraction in investment dollars in 2008, exhibited only a modest decrease in investment dollars, and little change in the number of investments. Total investments in 2009 were \$17.6 billion, a decrease of just 8.3% over 2008. Furthermore, a total of 57,225 entrepreneurial ventures received angel funding in 2009, a slight 3.1% increase from 2008, and the number of active investors in 2009 was 259,480 individuals, virtually unchanged from 2008. The small decline in total dollars, coupled with the increase in investments predictably resulted in a smaller deal size for 2009 (an 11.1% decline in deal size from 2008).⁵

Angel investment has a significant likelihood of generating job growth. The United States Census dataset called Business Dynamic Statistics (BDS) indicates that first year businesses add 3,000,000 jobs a year on average in the country. The BDS measures business openings and closings, startups, job creation and job destruction by firm size, age, industrial sector, and state. The U.S. economy is made up of more than 6,000,000 businesses with paid employees. The population of these businesses is constantly increasing and declining. Businesses grow, shrink, and close. New businesses constantly replenish this pool and do not simultaneously lose jobs. Therefore, it is first-year businesses that are creating net positive job growth.⁶

The individual investor contributes to the success of the business by providing more than just funding. Angel investors are “widely distributed” and because they make the majority of their investments “locally (within 50-100 miles of where they live)...they are able to address regional gaps in the availability of finance.” They typically “seek to contribute their experience, knowledge and contacts to the benefit of their investee businesses” which increases the likelihood of the entrepreneurial business venture being a success.⁷ “The presence of angel investors also reduces the relocation of successful entrepreneurs to the coasts for early-stage financing so that states realize greater economic impact from entrepreneurial startups.”⁸

What Does Kentucky Have in Place Currently?

Kentucky already has a modest program in place to promote private investment in high-tech start-up business ventures. The Kentucky Investment Finance Act (KIFA) was first enacted in 1998 to encourage capital investment in the Commonwealth, to encourage the establishment or expansion of small business in Kentucky, to provide additional jobs, and to encourage the development of newer products and technologies in the state through capital investments.⁹ The Act was expanded and improved upon by amendments that became effective July 15, 2002 resulting in the current program.¹⁰

KIFA provides a tax credit for investors in high-tech and start-up companies. Taxpayers invest through a fund of at least \$500,000 with a fund manager approved by the Kentucky Economic Development Finance Authority (KEDFA). The fund manager applies to KEDFA on behalf of the fund. The criteria for fund manager approval include compliance with state and federal laws, investment strategy, the experience of the fund manager, and demonstrated ability of the fund manager to manage the fund.¹¹ The structure, therefore, contemplates a paid fund manager making investment decisions and controlling a pool of money invested by individuals. The individual investors in the approved fund may be eligible for a credit against income tax, insurance taxes and taxes on financial institutions of up to 40 percent of that investor’s proportionate share of qualified investments.¹²

To qualify for the credit, the fund must invest in a “small business” as defined in the Act and the small business must be engaged in a “qualified activity” as defined in the Act.

"Small business" means any entity which at the time a qualified investment is made by an investment fund:

(a) 1. Has a net worth of five million dollars (\$5,000,000) or less or net income after federal income taxes for each of the two (2) preceding fiscal years of three million dollars (\$3,000,000) or less; or

2. Is a knowledge-based business, as shall be prescribed by the commissioner of the Department of Commercialization and Innovation, and has a net worth of ten million dollars (\$10,000,000) or less;

(b) Is actively and principally engaged in a qualified activity within the Commonwealth, or will be actively and principally engaged in a qualified

activity within the Commonwealth after the receipt of a qualified investment by an investment fund;

(c) Has no more than one hundred (100) employees; and

(d) Has more than fifty percent (50%) of its assets, operations, and employees located in Kentucky.

"Qualified activity" means any industrial, manufacturing, mining, mining reclamation for economic development, commercial, health care, agricultural enterprise, or agribusiness activity. A "qualified activity" does not include any activity principally engaged in by financial institutions, commercial development companies, credit companies, financial or investment advisors, brokerage or financial firms, other investment funds or investment fund managers, charitable and religious institutions, oil and gas exploration companies, insurance companies, residential housing developers, retail establishments, or any activity that the authority determines in its discretion to be against the public interest, against the purposes of KRS 154.20-250 to 154.20-284, or in violation of any law;¹³

Funds must submit an annual report to KEDFA that includes information on the amount of investments, the businesses in which the fund invested, and the job creation anticipated and achieved by the business receiving the investment. The information reported is used to determine the amount of tax credit available to the fund which is then reported to the Department of Revenue. It is up to the fund to distribute the credit among its investors who then claim the credit when they file their tax returns. The fund manager must also provide an annual audit prepared by an independent certified public accountant in accordance with generally accepted accounting principles. KEDFA in turn files an annual report with the legislature.¹⁴ The reports for 2009 and 2010 are attached as **Appendix A** and **Appendix B**.

The total cap on the KIFA program is \$40,000,000 and the total cap for any single fund is \$8,000,000.¹⁵ There have been two versions of the KIFA program (herein KIFA I and KIFA II respectively). KIFA I had only one participant fund, while KIFA II, the current version, had seven approved funds. Of those seven KIFA II funds, three withdrew and never were active participants in the program, leaving four remaining active funds. Note that the 2010 report includes only three of the KIFA II funds because one of the four KIFA II funds reached its maximum approved investment and is no longer eligible to participate. (See **Appendices A and B**.)

There are three different measures of activity under the program. As with many of the performance-based incentives, KEDFA approves a maximum tax credit amount available to the fund. The amount for which the investors in the fund are ultimately eligible is determined by the actual investments made. Finally, after the credits are apportioned among the taxpayer investors, it can be determined how much each one is able to claim against his own tax liability, or transfer, for consideration, to other taxpayers. There are therefore likely to be different dollar figures for the maximum approved credit for a fund, the amount actually available after investments are made, and the total of the amounts claimed by taxpayers on their separate returns.

The five funds that have actively participated in either of the KIFA programs since inception each had a maximum approved credit amount. The total aggregate approved amount of tax credits for all participants (KIFA I and KIFA II) was \$6,763,672. After this credit amount was approved, those funds submitted their investments for approval of an actual available credit. Those five funds have made a total of \$13,223,598 in qualified investments since 2000. As of June 30, 2010, the aggregate credit available for all investors under this program was \$4,957,495. Although the Cabinet is not privy to the actual credits taken by the investors, the amount of credits taken by those investors is most likely less than that number due to the fact that some of the investors are non-profits or did not have tax liability and, therefore, did not claim or transfer all of the available credits. The five funds and their investment totals are set forth in the figure below.

Figure 1

FUND NAME	QUALIFIED INVESTMENTS IN KENTUCKY COMPANIES
Kentucky Venture Fund (Old KIFA Program)	\$4,581,250
Evermore Investment II, LLC	\$1,619,852
Chrysalis Ventures, LLC	\$2,500,000
Yearling Fund I, LP	\$1,675,178
Kentucky Seed Capital I, LP	\$2,847,318
TOTAL QUALIFIED INVESTMENTS	\$13,223,598

In an effort to evaluate the program from the perspective of the participants, the Cabinet for Economic Development conducted a survey. All applicants (whether approved or not), including those who inquired about participation recently, and all approved fund managers were asked to complete and return it. The survey is attached as **Appendix C**. The nine responses received indicate the following.

Comments from KIFA Survey Responses

(Quoted exactly as submitted in the survey response)

Has the fund benefited from the incentives and, if so, how [in dollars or general terms]?

- *Yes, the tax credit made an investment in the Fund more attractive, so it was easier to raise money for the fund.*
- *Yes, \$1 Million (the full amount) was passed through to investors – this provided good will to the firm and additional net return to the investors.*
- *Yes, 40% return to investors*

- *Yes. We have been able to attract additional investors and dollars into the fund, and invested over \$1.6 million in qualified entities generating \$648,000 in credits.*
- *Yes!! \$1.6 Million allocation with \$670,000 use to date.*

Have individual investors benefited from the incentives and, if so, to what extent [in dollars or other general terms]? (A general description is acceptable if confidentiality is an issue.)

- *Yes, through 2009, 21 of our investors have received about \$729,900 in tax credits.*
- *Yes. The individuals in Kentucky were eligible and received the benefit of \$1 million in tax credits collectively from 2005-2007 (eligible for use 2006-2008)*
- *Yes, \$670,000*
- *Yes. As stated, individual investors have received 100% of the \$648,000 in tax credit allocations due to the fact [fund] is a pass-through entity.*
- *Yes. We are a \$3.150 million Fund. The allocation and use to date become very meaningful for KY taxpayers.*

Describe any difficulties you had with the program requirements or terms:

- *The process for review of a draft application went smoothly. More public disclosure about this option would be helpful.*
- *Requirement that tax credits only apply to fund automatically disqualifies benefits to investments made by individual [fund] members – other states have incentive programs for individual investors.*
- *Requirement that no single investor have more than 40% of the fund may be reasonable, but should not count investments in funds made by the Commonwealth – this automatically disqualified the first [fund].*
- *Requirement that the fund have a professional manager and a yearly formal audit has caused concern among managers of new [fund]. This fund is managed by a highly experienced group of volunteers with the specific goal of minimizing overhead costs to its members; e.g., there is no management fee or carry. The professional manager and yearly audit add significant overhead costs.*

- *The only issue concerned the interpretation of the agreement about how much of an awarded tax credit could be claimed by an investor in a given year. This has been resolved.*
- *No difficulties.*

The survey indicates that the fund and fund manager structure of the program is a deterrent in some circumstances. However, those that have taken advantage of this opportunity have made significant investments beneficial to the state. If a separate individual investor (angel) tax credit program is created, some of the concerns expressed with regard to the current KIFA program may be addressed by giving the less formal investor groups another option for recovery of tax credits. While some added flexibility would be beneficial to the program, the safeguards that exist were included to protect the state and revisions should be carefully considered.

A 2008 study done at Belmont University identified states that had angel investment programs and selected 4 as samples to specifically study. Kentucky was selected for its hybrid program that combines potential tax credits for individual accredited investors with a seed/venture capital program.¹⁶ The study notes that the requirements related to formation of a structured fund differ from other states, but also notes that this structure indicates Kentucky is “keeping a close eye on its program, to prevent abuse”.¹⁷

The author referred to the Kentucky program as a hybrid because of the additional seed funding available through the Commonwealth Seed Capital Fund, LLC. The Kentucky Economic Development Partnership Board formed this separate LLC and provided state funds to the LLC. The fund has been directed to make investments that promote the development of seed and early stage high-growth potential technology based companies throughout the Commonwealth.¹⁸ The LLC has committed \$6,270,000 to 16 different Kentucky companies and \$13,500,000 to other seed funds since it was formed in 2001. An itemized list of the investments to date is included as **Appendix D**. (Note the annual report at **Appendix D** indicates over \$8,000,000 in committed funds, but that number includes some follow-on investment not officially approved by the Management Committee of the LLC.) Other interesting statistics regarding those investments are reflected below.

Figure 2

Commonwealth Seed Capital Results to Date (since June 2001)	
Direct investment commitments in 16 seed-stage companies and 9 fund-of-fund investment commitments	
Committed to companies:	\$6 million
High-tech jobs created:	57.5 high-tech jobs with \$4,168,409 payroll
Committed to funds:	\$13.5 million.
Funds have invested:	\$40,462,273 in 18 Kentucky companies
High-tech jobs created:	250

*NOTE: Job data in Figure 2 is self-reported by the companies or funds and was not verified by the Cabinet.

Is an individual investor tax credit necessary for Kentucky to remain competitive?

The information above gives the reader an idea of what Kentucky has in place. The question relevant to this study is whether the investment incentives available now are sufficient to keep Kentucky competitive with other states and, if not, what would make Kentucky competitive. The Belmont study of states with some form of angel investment incentive included Kentucky, so clearly the term was used in the broadest sense and includes individual investor incentives, fund investor incentives, and other non-traditional programs deemed by the writers of the Belmont study to be eligible for inclusion.¹⁹ That study was conducted in 2008, and five programs have been added since then.

For a general survey of what other states are doing, the Cabinet looked at several of the states that have been historically considered to be competitors for Kentucky. **Appendix E** is a chart that shows a direct comparison of Indiana, North Carolina, Ohio, Virginia and West Virginia programs. The Cabinet also reviewed two other states that had particularly interesting approaches, good impact information, or significant recent developments. (See **Appendix F**.)

OHIO

Ohio's Technology Investment Tax Credit (TITC) program was created in November 1996 to stimulate the formation of new Ohio ventures that utilize technology to create new products, services, and new processes for commerce in global markets. The program provides a 25 percent tax credit for taxpayers who invest in emerging, Ohio-based research and development and technology-based companies. This tax credit program ensures a leverage ratio of three private dollars to every one public dollar to support the growth of early-stage technology companies.²⁰ The tax credit is raised to 30 percent of investment amount if the investment is in a business located in a distressed county.²¹ The cap on the program was originally \$30,000,000, but the legislature increased that cap to \$45,000,000 in the 2009 legislative session.²² The program administrator by telephone confirmed that as of October 15, 2010, the program has issued over \$33,000,000 in tax credits so it is likely to reach its cap and seek additional cap from the legislature in the future.

Development professionals from Northern Kentucky have indicated to the Cabinet that Ohio has a significant advantage over Kentucky in the area of angel investment tax credits. The Northern Kentucky Tri-County Economic Development Corporation ("TriEd") submitted a white paper to the Kentucky General Assembly January 21, 2010 to document the competitive environment in which they are operating. (**Appendix G**.) On page 9 of that paper, TriEd provided a direct comparison of the angel investment programs available in Ohio and Kentucky.

That comparison indicates that Kentucky's program at that time had a higher cap (\$40,000,000 in Kentucky v. \$30,000,000 in Ohio) and a higher recovery percentage (40 percent Kentucky v. 25 -30 percent Ohio). However, despite what seems to be a more generous offering in Kentucky, the Ohio program approved \$26,100,000 in tax credits

since the inception of its program, while Kentucky approved \$6,700,000 since its inception. (This includes the credits approved, but not necessarily taken in Kentucky and it is assumed that the Ohio figure similarly is for committed credits as opposed to credits actually taken.) On the other hand, Ohio's population is about 11.5 million, compared to Kentucky's 4.3 million. Ohio's credit amounts to about \$2.27 per capita and Kentucky's are about \$1.56 per capita.

According to the TriEd document, the private investment related to the program incentive in Ohio was reported to be \$109,800,000, while Kentucky's program generated only \$16,800,000 in investment, which is actually a number higher than that in the Cabinet's 2010 KIFA Report, but may include additional investments made by funds but not submitted for credit recovery. TriEd proposes that the difference between the two state outcomes is purely due to the fact that the Ohio tax credit is available to individual investors, while the Kentucky KIFA program is limited to funds. Note that the more current total for issued credit in Ohio has gone up to \$33,400,000 and the private investment figure has risen to \$133,800,000 since the TriEd paper was written, according to the program manager for the Technology and Innovation Division under the Ohio Department of Development. The same source indicated that \$183,400,000 in credits have been approved and that 3,901 investments have been made at an average of \$34,000 per investment.

Ohio's Third Frontier Program was established in 2002 as a 10-year initiative to foster the creation of high-paying jobs through innovation and commercialization. The program was originally funded at \$1,600,000,000 to be used for various forms of incentive including grants, loans and tax credits. The program generated widespread attention for its large infusion of \$700,000,000 in cash in 2010²³ at a time when cash programs are being reduced in other states. That infusion is not related to the TITC angel investor program described above, but the legislative increase of the cap on TITC was significant in 2009, as indicated above, and the combination of the Ohio Third Frontier cash with the TITC increase gives the perception that New Economy activity is a priority in Ohio and the state is becoming entrepreneur-friendly. While Kentucky already has competitive state funding programs in place for each of those offered by the Third Frontier, it does not have individual investor incentives equivalent to the TITC.

INDIANA

Indiana has a Venture Capital Investment Tax Credit which allows both individuals and entities to qualify for taxpayer credits. The credit can be applied to income tax, financial institutions tax and insurance premium tax. The credit maximum is the lesser of 20 percent of investment or \$500,000 per business.²⁴ The Indiana Economic Development Corporation (IEDC) processes applications from both the businesses seeking to qualify for investments and the taxpayer/investor seeking certification that their investment plan will make them eligible. The taxpayer then has two years to make investments consistent with its investment plan in businesses that are certified and submit investment proof to IEDC which then provides a letter confirming the taxpayer is eligible for the credit. Headquarters and high-tech businesses can be certified as qualifying for

investment. The Indiana statute includes a broader range of qualifying business types as compared to most other states' programs.²⁵

The IEDC 2008 Annual Report indicates that the investment dollars pledged in its first four years exceed \$28,000,000.

The VCI tax credit represents a significant incentive to these early stage investors to invest in Indiana's high-potential, young companies. In 2008, 48 Indiana companies were qualified as VCI eligible with plans to utilize the VCI tax credit to raise \$91.6 million in venture capital funding. Since the program's inception in 2004, the number of investment dollars pledged to program companies by investors has increased each year and now totals more than \$28.2 million. The number of investors utilizing the program also continues to increase each year with more than 1,300 angel, venture capital and corporate investors in our database.²⁶

When compared to KIFA's \$13,000,000 in investment dollars, this program seems to be a successful incentive for investment. Indiana does have an annual cap of \$12,500,000 for the program as a whole, but does not have the total program cap that Kentucky has (\$40,000,000). The program was due to sunset in 2008, but was extended through 2012.

NORTH CAROLINA

North Carolina's program is very similar to Indiana's and Ohio's. North Carolina offers a Credit for Qualified Business investments of 25 percent of the amount invested up to \$750,000 for pass-through entities annually and up to \$50,000 for each individual owner of a pass-through entity.²⁷ Other individual investors have a cap of \$50,000 annually also. The maximum allowable annual credit committed is \$7,500,000. To become a qualified business eligible for investments, the business must register with the Secretary of State. The parameters for a qualifying business are less restrictive for North Carolina. A business does not have to be high-tech to qualify, but high-tech may qualify as well as other types.²⁸

This program differs from the other state programs reviewed thus far because the administration is handled by Department of Revenue and the qualification of businesses for investment is handled by the Secretary of State.²⁹ The reports for this program track the businesses registered to receive investment under the program and there were 136 qualifying businesses in 2009. The annual program cap started at \$6,000,000 in 2001 and grew to \$7,500,000. The credits applied for in some years exceeded the available cap and, as a result, the credit claimed by each taxpayer for the respective year was reduced by the following percentage rounded to the nearest whole number:

35% - 1997
7% - 1999
15% - 2000
68% - 2001
23% - 2002

13% - 2004
9% - 2006
26% - 2008

The North Carolina Department of Revenue provided information regarding the aggregate credits claimed and investments made. The full report is included as **Appendix H**, but most importantly the report indicates a total of \$636,531,655 in investments made by individuals, corporations and pass-throughs since 1988 with a total revenue impact to the state of \$106,492,971 (credits allowed). North Carolina's angel investor tax credit program has resulted in approximately 660 new jobs per year in high-growth companies providing average wages of \$58,792.³⁰

VIRGINIA

Virginia has a Qualified Equity and Subordinated Debt Investment Tax Credit program which authorizes the approval of tax credits for individual or entity investors/taxpayers. Virginia has one of the higher credit percentages at 50 percent of investment with a \$50,000 annual cap for each taxpayer.³¹ The annual cap for the program is \$5,000,000 and one-half of the total available credits must be allocated exclusively for commercialization investments, making them a priority for the program.³² The program is administered by the Department of Taxation. While current data on impact was not accessible, an article in the Hawaii Law Review indicates that between 1991 and 2001 Virginia exceeded its annual cap (at that time \$6,000,000), 200 companies received approximately \$100,000,000 in investment, and the capital was invested by 200 different investors.³³ Assuming cap was met each year since then, the program may have generated significantly more than that over the last 9 years since that measure was taken.

WEST VIRGINIA

The West Virginia High-Growth Business Investment Tax Credit program is very similar to the Virginia program and provides the same 50 percent investment income tax credit to both individuals and entities. The Economic Development Authority does administer this program and processes applications for tax credits. West Virginia's program has an annual cap of \$50,000 per investor, but has a very restrictive total program cap of \$1,000,000. There is also a \$1,000,000 cap on the amount that any one business can accept from eligible taxpayers. The credits are limited to investments in research and development companies that maintain a corporate headquarters in West Virginia. The credit is applied against both franchise and income tax.³⁴ The administrator indicated that the program is no longer active although the statutory authority remains.

HAWAII

Although Hawaii is obviously not close in proximity to Kentucky and is not a state that Kentucky often competes with for new facility or expansion projects in the traditional economic development market, its investment tax credit is worth consideration due to its history and its cost. The High Technology Business Investment Tax Credit can be taken by approved individuals, companies, insurance underwriters, fiduciaries and other exempt organizations. The exempt organizations may benefit by transferring credits

they have earned under the program. To be qualified to receive the investment, the business must derive more than 75 percent of its gross income from qualified research in the state.³⁵ The program is administered by the Department of Taxation.

The unusual aspect of the Hawaii tax credit is that the investor may recover 100 percent of its investment in high-tech businesses spread over 5 years: 35 percent the year of investment up to a maximum of \$700,000; 25 percent the second year, up to a maximum of \$500,000; 25 percent the third year, up to a maximum of \$400,000; and 10 percent in the fourth and fifth year, up to a maximum of \$200,000 in each of those years. The maximum recoverable for any single taxpayer is \$2,000,000.³⁶ This program also includes a recapture provision so that tax credits may be recovered by the state in an event of non-compliance. Note that Hawaii also provides a 20 percent credit to investors in research and development businesses.³⁷

Hawaii was also selected for review because they have a formal impact report for calendar year 2008 which provides measures of impact to the state. (**Appendix I.**) This report was generated as a result of legislation passed in 2007 requiring the qualified businesses receiving the investments to file a survey covering information for the past 5 years. It is difficult to confirm complete accuracy since businesses not seeking additional investment for years following the passage of the legislation may not have complied. The qualifying businesses that did comply reported receiving a total of \$1,369,000,000 in cash investments between 2000 and 2008. The cost to the state is estimated to be over \$775,000,000. However, that number does not include the credits approved by the state but not claimed to date which number is estimated to be \$593,000,000. “[W]hen this data is broken down by the income level of the taxpayer, over 96% of the total amount of credits claimed was by individuals with adjusted gross incomes of \$200,000 or more.”³⁸

The history of the Hawaii tax credit program is also interesting. The first program passed by the legislature in 1999 provided a credit of only 10 percent of the investment and an annual cap of \$500,000. The 2001 amendment to the program statute increased the credit percentage recoverable to 100 percent. In 2009, the Hawaii Legislature placed a temporary limit on recovery. Hawaii Revised Statute, Section 235-109.5 states that claims cannot exceed 80 percent of taxpayer’s liability for the period from January 1, 2009-January 1, 2011. To emphasize, that limitation is not on the percentage of investment, but on the percentage of the particular taxpayer’s liability, presumably to reduce revenue impact to the state budget during this economically challenging period.

The reader is encouraged to review *The Impact of the High Technology Business Investment Tax Credit on Hawaii’s Economy for Calendar Year 2008* at **Appendix I.** The report includes additional data on the jobs created as a result of the investment consistent with the claims made in studies and articles with regard to the kinds of jobs and wages that this type of investment brings.

Prior to the release of the report at **Appendix I,** David H. Hu wrote an article for the University of Hawaii Law Review to provide some analysis of the success of the program.³⁹ If success is measured strictly by the amount that investment exceeded

credits, Hawaii would be deemed a success. (A more common measure is the amount by which the *additional tax receipts* generated as a result of the investment exceed the amount of the credits.) However, unless the businesses created remain in Hawaii, the investment benefit is reduced as is the rate of success. In Hawaii, the lack of venture capital necessary for these start-ups to grow may limit the actual success.

....[T]he research and development and seed capital it generates has not developed a critical mass of strong young companies capable of attracting private venture capital to Hawaii. Without venture capital financing, entrepreneurs and companies benefiting from research and development as seed capital investments under [the program] are forced to look outside the state for later stage funding.⁴⁰

KANSAS

The Kansas Angel Tax Credit is a tax credit of 50 percent of the investor's qualified investment up to \$250,000 each year per entity investor or \$50,000 per year per individual investor. The current annual cap for the program is \$6,000,000, up from the original cap of \$4,000,000.⁴¹ When evaluating business to determine whether it will be certified as an eligible investment, first consideration must be given to animal health companies, but high-tech is not necessarily a requirement. To qualify for the credits, the investor must be accredited with the Securities and Exchange Commission and must have a high net worth, a requirement not found in most other states. The Kansas Technology Enterprise Corporation (KTEC) is the administrator for the program and is a state-owned corporation as opposed to a state agency.⁴² This program does not approve businesses until the investor requests approval for the credit as opposed to having the businesses seeking investment approved in advance of finding the investor.

The 2009 Annual Report indicates the following:

Figure 3

	2008	Total From Inception
Total Angel Tax Credits Issued	\$6,606,083	\$13,375,117
Number of Investors Receiving Credits	218	566
Number of Companies Receiving Investments	28	73
Total Capital Raised	\$37,437,499	\$118,826,159
Total Annual Payroll	\$22,426,253	\$51,496,293
Total Revenue	\$57,409,422	\$119,426,701

COMMON PROGRAM TERMS

Within this brief survey of eight states (including Kentucky) there are a few common aspects of the programs. All of the states, other than Kentucky, specifically allow for individual investors. Kansas is a bit more restrictive as to the qualifications of the investor. Others allow any individual or entity taxpayer to invest. All of the states have some parameters for businesses qualifying to receive the investment. Some of the states are restrictive with regard to the type of business that can qualify to receive the eligible investments. Others are less restrictive.

All of the programs allow taxpayers to recover a percentage of the eligible investment, but the percentage ranges from 25 percent up to 100 percent. Some states have per taxpayer caps. Some have caps on the amount of eligible investment the qualified business can receive. Most states have either an annual recovery cap for the program in the aggregate or a total program cap in aggregate. All of the programs reviewed had non-refundable credits meaning that they can only be applied to tax liability and no check is issued to those without tax due. Recovery is also allowed to carry forward in most programs, but the period of carry-forward varies.

Clearly, the states identified in this document can show that the private dollars invested into the state exceed the credits taken. Hawaii far exceeds the others for both the investment generated and the cost to the state, with North Carolina achieving second place based on those overly simplistic measures. There does not appear to be data regarding how many of those businesses receiving the investment were more successful because of the investment. Some states did show job creation as a result of the investment and the general industry data indicates those jobs will be high-paying jobs.

It seems logical that competition for investors would be somewhat limited by the fact that the investor must have tax liability in the state in order to seek out investment opportunities in the state or must have an option for transfer of its credits. It is possible that the businesses receiving the benefit of these investments are competing with other investment opportunities within the same state for the same investment dollars. However, the authors of this paper found no studies or articles analyzing that possibility.

Because of the riskier nature of start-up high-tech type business ventures, an investor needs some additional motivation to take the risk of investing in them.

Many angel investors are enthusiastic about tax credits because credits increase angels' return on investment. However, the economic benefits of the investment tax credit to states are unknown because of the lack of data and the difficulty of measuring economic impacts. Some believe credits likely increase the size of completed deals but that they are unlikely to increase the number of ventures funded because they do not improve deal quality...New investment tax credits reward not only new angels but also those already actively investing, lowering the benefit-cost ratio of tax credit.⁴³

Individual investor credit programs are gaining interest and influence as indicated by the number of states that have recently passed legislation or have recently considered

legislative proposals related to individual investment incentives. Connecticut, Georgia, Illinois and Minnesota all passed angel investor tax credit legislation in 2010.

Ohio has not only targeted the angel investor by increasing its cap on the program identified above, but has injected \$700,000,000 into high-tech industry sectors through its Third Frontier program in an effort to jump-start its economy. Kentucky already has several successful publicly funded programs in place that target high-technology businesses, but has nothing that fills the private funding gap for seed-stage, high-tech companies the way individual tax credits have in other states.

Which of the current investment tax credit options is most likely to be beneficial to the Commonwealth?

In order to determine which programs might be most beneficial, the state must first determine what its goals are in creating an individual investor tax credit. The goals could be as broad as stimulation of investment and job growth or as narrow as stimulation of a very limited level of investment in a single type of businesses. The state must determine the type of business it intends to benefit from the investment, and what other terms will be sufficient to attract investors in those businesses, as well as how best to enforce the program's requirements. The individual investor incentives appear to attract more investment than Kentucky's fund investor incentive and represent the current trend in economic development tools, so it is assumed that any new programs for the Commonwealth would include eligibility of individual investors.

1. Kentucky Presence: In order to tie the benefit to the state, the business eligible to receive the investment must be located in Kentucky. All of the programs reviewed for this study (including Kentucky's existing KIFA program) require that the business receiving the eligible investment be located primarily in their own state. That is a given for the success of any new incentive in Kentucky. Parameters for measurement of state presence vary.

2. Business Size: Most of the states specifically limit the size of businesses eligible to receive the investment. Size is measured using annual revenue. The parameters range from \$2,500,000 up to \$10,000,000 net annual revenue. The assumption is that a start-up business or a riskier venture will have less revenue and businesses with more significant revenues will attract venture capital investment or qualify for other traditional funding structures without incentive. The goal of most programs is to serve seed-stage companies that don't have private funding options.

3. Business Type: Indiana and North Carolina allow a wide range of business types to qualify for investment, including manufacturing businesses and service industry. Most other states reviewed limit the eligible businesses to one or more of the industries traditionally recognized as high-tech. These parameters are driven somewhat by the types of businesses that attract individual investors.

4. State Revenue Impact: The allowable percentage of investment recoverable could be used to create a competitive advantage in Kentucky. KIFA already allows recovery of 40 percent investment which is higher than many. The legislature would need to consider what level of impact can be absorbed by the projected additional revenues from investment. If a new investment recipient remains viable because of the investment, then the revenues created by that business and its employees could help compensate for the credits provided. Evaluation of fiscal impact will be a necessity in determining the appropriate credit percentage for any new program. The impact has been capped in most states with maximum allowable annual recovery of credits by the investor, maximum total credits committed by the state annually, maximum eligible investment dollars for any one business or some combination of those caps. Some states cap the total impact for the program as opposed to providing an annual cap. Kentucky's KIFA program includes a total program cap.

It should be noted that any tax credit proposals for angel investments will likely carry a negative fiscal impact when the legislation is considered. While the potential dynamic economic impacts that would accompany further investments in Kentucky are profiled above, the traditional scoring of bills considers the static impacts only. Therefore, depending on the particular language provisions, a small to moderate negative fiscal impact will ensue. The tax credits will likely be taken to reduce tax liabilities (or refunds) by angel investors before the economic impacts can generate increased revenues to offset the cost of the credit.

The size of the negative fiscal impact will depend in part on the specifics of the proposal. Key elements include:

- Size of the tax credit to investors
- Is the credit refundable?
- Can corporations contribute as investors?
- Can investors use the entire credit in one year?
- Can investors also write off capital losses if the investment does not generate taxable income?
- Will there be a clawback on angel credits if investors "write-off" the loss?

One example of unintended consequences: On April 1, 2010, Governor Pawlenty of Minnesota signed into law the Minnesota Small Business Investment Tax Credit. Known as the "Angel Investment Tax Credit", one of the key features of the legislation is a 25% income tax credit on investments made in qualifying small businesses. As compared to Kansas' 50% or Hawaii's 100% credit, the Minnesota credit would seem uncompetitive. However, the Minnesota credit does not limit use of the credit to taxpayers who have liability for Minnesota income taxes. An out-of-state investor will be entitled to a refund in the amount of the credit, regardless of the lack of Minnesota taxable income, if the investor files a return in the state. While the overall cap on the program is \$11 million in tax years 2010-2011 and \$12 million in 2012-2015, the applications are approved on a first come first served basis and will be expected to be fully subscribed.

5. Other Factors: Other factors to be considered for any new program include the form of investment and allowable use of funds. Subordinated Debt and Preferred Stock are common investment vehicles. Some states allow a wider variety of debt instruments while others restrict the investment to ownership interest in the new company. A new program could also include restrictions as to the use of the funds. The program could require that some portion of the funds go directly to hiring of employees and payment of salaries and benefits. This is a more direct option for generating state revenues relative to the investment. It is assumed that more flexibility will create a program with a higher population of beneficiaries and motivate a higher level of investment.

There are other investment incentive program options available as well. Some states have a separate capital gains credit option either in addition to the individual investor tax credit or as an alternative to it. A few states are currently offering credits against capital gains for taxpayers forced to sell their business for economic or other reasons if the income gained from the sale is reinvested into a particular type of business (usually high-tech).

Beginning January 1, 2011, Wisconsin will permit taxpayers to defer Wisconsin taxation of long term capital gain proceeds, up to \$10,000,000, which are re-invested in qualified new business ventures, as certified by the Wisconsin Department of Commerce.⁴⁴ Wisconsin also has an angel investor tax credit in place and this capital gains incentive is an addition to its current available credit programs for investors.

Oregon also passed legislation on deferral of reinvested gains in the 2010 Special Session. O.R.S. Section 316.874 states that upon the sale or other disposition of a qualified business interest or asset, to the extent that an amount equal to the total of all gain deferred is reinvested in one or more qualified business interests, the gain will be deferred.

Virginia taxpayers will also soon have a capital gains tax exclusion for investors in qualifying technology startups. House Bill 523 was passed in the 2010 session of the Virginia Legislature. It was intended to improve availability of funding for companies immediately. It will be effective for taxable years beginning on or after January 1, 2011.

While it is difficult to find data on the effect of offering capital gains incentives, a January 2005 study by the European Central Bank concluded that a decrease in capital gains taxation typically raises the share of early-stage and high-tech investments.⁴⁵

Angel Investment Incentives are Consistent with Existing Economic Development Initiatives

Implementing an individual investor incentive program would benefit angels investing in high-tech companies and also help the Cabinet's Department of Commercialization and Innovation (DCI) accomplish its mission by motivating investment in businesses specifically within five technology focus areas. In 2002, the

Cabinet developed *Kentucky Innovation: A Strategic Plan for the New Economy*. The plan identified five priority technology focus areas for Kentucky that reflected the best opportunity to build centers of research excellence around which competitive technology-based clusters could grow. The five technology focus areas were:

- Material Science and Advanced Manufacturing
- Biosciences
- Human Health and Development
- Environmental and Energy Technologies
- Information Technology and Communications

Subsequently, in April 2007, DCI retained an independent consultant, RTI International, to develop a *Five-Year Kentucky Science and Technology Plan*. The plan assessed the state's innovation strengths and weaknesses, explored ways to build on successes, and also included an extensive inventory of current research assets and capabilities. Combining this information with research on federal funding, patents, market analysis, and other information, RTI recommended that Kentucky's five priority technology areas remain in place. The Department perceives individual investor programs as more than just a method of bringing new businesses, jobs and dollars to the state. The Department could use investor incentives to accomplish its mission by encouraging investment in businesses within one of those five technology focus areas.

Conclusion

Emphasizing angel investment in high-tech ventures in Kentucky would encourage greater participation by investors who typically see high-tech investments as being riskier, but who also perceive them as having a higher potential pay-off should they be successful. Angel investment programs eliminate some portion of that risk by providing some form of return for their investment.

The addition of incentives for individual investors would not necessarily spell the demise of the KIFA fund investor incentive. It is quite possible to maintain both types of incentive if the state budget can accommodate them both. The KIFA survey indicates that those funds determined eligible for tax credit recovery have benefited from the program and have made investments in Kentucky as a result of the program. Based on the evaluation of the program, it may be time to reduce some of the stringent requirements for fund managers in order to reduce the cost to the fund.

DCI now has in place a state funding program for every stage of technology commercialization, from concept development through business growth and development. A program to encourage private funding for technology commercialization would greatly enhance the resources available to the Kentucky's high-tech start-up firms. Should the legislature provide this gap-filling option, Kentucky would not face the total lack of available venture funding that Hawaii did (where there was little or no assistance for the next stage of development). However, there is still a need for more sources of

private venture capital to enable Kentucky companies to remain in the state as they grow beyond the angel funding stage.

Incentives like the individual investor tax credit and the capital gains deferral would provide a new private funding source for Kentucky entrepreneurs and would likely generate interest in Kentucky similar to the successes experienced by other states.

The Angel Capital Association estimates that about 225,000 people made an angel investment in the last two years (including accredited and non-accredited investors) and that approximately four million more people each with a net worth of \$1 million or more could become angels in the U.S.⁴⁶ In 2009 it was estimated that there were 57,059 households in Kentucky with \$1 million or more in investable or liquid assets.⁴⁷

The effects of the 2008-2009 recession seemed to be wearing off during the first quarter of 2010 as seed investment deal flow increased to 26% (from 4% in first quarter 2009; a 6.5X increase).⁴⁸ Overall venture capital deals in the third quarter of 2010 were at a near eight-quarter high, with seed deals emerging across all sectors. The emergence of seed venture capital deals across a variety of sectors, not just internet, also indicates a healthy early-stage investment environment.⁴⁹ The angel investor market in the first and second quarters of 2010 showed signs of stabilization since the 30 percent market correction in the second half of 2008 and the first half of 2009.⁵⁰

The benefits of angel investments to startup companies cannot be overstated. Angel investments improve entrepreneurial success. Companies receiving angel investments have a higher survival rate (more than 4 years), are better able to obtain additional fundraising outside the angel group, and have a faster growth rate. The improvements typically range between 30 and 50 percent.⁵¹

Kentucky businesses, investors, workers and the Commonwealth's economy would all benefit from an Angel Tax Credit:

- Kentucky businesses would receive the capital they need to grow.
- Investors would be better able to manage the risk associated with investing in a new Kentucky businesses or technology.
- Kentucky workers and the state's economy would benefit because the tax credit would help kick-start emerging businesses and create new jobs.

Given the popularity of tax credits, including angel investment credits (in 25 states as of 2010), and the widespread understanding of how tax credits work, it would be relatively easy to attract angel investment based on the availability of a tax credit. In addition, since some tax advisors also function as investment advisors, they would naturally gravitate toward investments that yield immediate tax benefits, such as an angel tax credit would provide.

The availability of a tax credit will enable Kentucky businesses to attract larger amounts of angel investments, because the tax credits lower the investors' net cost of their investment (i.e., they can buy the same share of the business at a lower cost because

the credit reduces their Kentucky tax). One reason for the success of similar credits in other states is that it acts as a form of “insurance” for angels when they make risky investments. Most innovation-based companies are considered a riskier investment because they are commercializing an unproven product or service. Providing a tax credit safety net for the angels could provide much-needed investment dollars to these companies developing tomorrow's innovations. A November 2007 academic study of angel investments found that angels lose some or all of their money in 52 percent of their investment deals because the companies go out of business. The most sophisticated angels make at least ten investments in order to make a return on their investment, counting on one or two to provide nearly all of their return.⁵²

Angel investments are becoming more popular compared to other sources of funding. In an October 2010 survey, the majority of heads of high-tech startups indicated they expected their next round of funding to come from individual angels or several angels (68%; up from 59%), early-stage VC firms (39%; up from 19%) or from super angel funds (37%). With more funding available, startup CEOs plan to seek less funding from friends and family in subsequent funding rounds (26%; down from 32%). Seeking funding from traditional VC firms increased marginally to 22%, up from 17%.⁵³

An Angel Investor Tax Credit would be a significant and positive move to promote the development of start-up companies in Kentucky. This measure, along the other credits and initiatives available to Kentucky companies, would confirm the Commonwealth’s enduring commitment to supporting entrepreneurship.

#

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CABINET FOR ECONOMIC DEVELOPMENT

Steven L. Beshear
Governor

Old Capitol Annex
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ThinkKentucky.com

Larry M. Hayes
Secretary

MEMORANDUM

To: The Honorable Bob Leeper, Senate Co-Chair
The Honorable Rick Rand, Representative Co-Chair
Interim Joint Committee on Appropriations and Revenue

From: Donna E. Duncan, Commissioner
Department of Financial Incentives

Date: October 15, 2009

RE: Kentucky Investment Fund Act (KIFA) Annual Report

On behalf of the Kentucky Economic Development Finance Authority, I am submitting the attached annual report for the Kentucky Investment Fund Act (KIFA) for the fiscal year beginning July 1, 2008 and ending June 30, 2009. This report is being submitted in accordance with KRS 154.20-264(2).

Please distribute as appropriate.

Please feel free to contact me if you have any questions regarding this report.

Cc: Gene Fuqua
Catherine Staib

Kentucky Investment Fund Act (KIFA)

Annual Report July 1, 2008 through June 30, 2009

The Kentucky Investment Fund Act (KIFA) provides a 40 percent state tax credit to individuals and corporations that invest in venture capital funds approved by the Kentucky Economic Development Finance Authority (KEDFA) when the approved fund invests in qualifying small Kentucky companies.

This report is divided into two sections. The first section provides information regarding the fund approved under pre-2002 legislation. The second section presents those funds approved under current legislation.

Section I

Under the law as it existed prior to July 1, 2002, KEDFA approved the Kentucky Venture Fund, LLC, on November 18, 1999, as its first and only approved venture fund under the Act. The \$5 million fund was approved for a total of \$2,000,000 in KIFA credits. Related investment activities are listed below. Under the provisions of the prior law, this fund was required to provide a listing of investors and total cash contributions prior to the approval of credits and the making of any investments.

- I. Kentucky Venture Fund –
 - A. Total number of approved credits - \$2,000,000
 - B. Number of investors – 16 (categories of investors unknown)
 - C. Amount of cash contributions - \$4,965,000
 - D. Qualified investments - \$4,573,750
 - 1. Nature of the business: Rehabilitation hospital
Location: Florence, Kentucky
Amount originally invested: \$1,241,250
 - 2. Nature of the business: Rehabilitation hospital
Location: Louisville, Kentucky
Amount of originally invested: \$1,241,250
 - 3. Nature of the business: Medical device supplies
Location: Louisville, Kentucky
Amount originally invested: \$1,241,250
Nature of the business: Healthcare Software Company
Location: Louisville, KY
Amount originally invested: \$850,000
 - E. FYE 2009 Activity – During the previous reporting period (2008), Kentucky Venture Fund, LLC was in the process of dissolution and had hopes of accomplishing that task by the end of 2008. The Kentucky Economic Development Finance Authority (KEDFA) approved the Fund's request for dissolution on December 11, 2008. Effective as of December 31, 2008 the Fund filed and the Kentucky Secretary of State had processed Articles of Dissolution for the Kentucky Venture Fund, LLC. This final step completed the Fund's activities in the KIFA program. This Fund will not be included in future annual reports.

Section II

The allocation of tax credits under the new law began in 2003. As of June 30, 2009, seven venture capital groups have accessed this program receiving an aggregate total of \$6,763,672 in approved credits. One fund reached its maximum amount of allowed credits under the fund's KIFA agreement prior to this reporting period. Three funds received approval for credits authorized during this reporting period totaling \$240,358. Three of the seven approved funds failed to meet annual qualified investment requirements over the history of the program and were withdrawn from the program.

Under current law, KEDFA provides a one-time approval for a maximum amount of credits to be authorized for a single fund. Cash contributions are documented at the time of each investment and approved as qualified investments are made. Eligible credits are then prorated among the individual investors based on the amount of individual cash contributions.

The venture capital funds receiving authorization of credits during this reporting period are as follows:

- I. Yearling Fund I, LP –
 - A. Total maximum approved credits - \$1,300,000
 - B. Number of investors: 30 (23 individuals, 6 for-profit entities, 1 non-profit)
 - C. Total amount of qualified investments to date - \$ 1,645,178
 - D. Total amount of authorized credits for this period - \$ 8,435
 - E. Total amount of authorized credits to date - \$553,616
 - F. Total Investments of \$ 25,064.14 certified for report period 7/1/08 thru 6/30/09
 - 1. Nature of the business: Packaging
Location: Louisville, Kentucky
Investment amount: \$25,000
KIFA credits authorized: \$8,413
 - 2. Nature of the business: Internet
Location: Louisville, Kentucky
Investment amount: \$64.14
KIFA credits authorized: \$22

- II. Kentucky Seed Capital I, LP
 - A. Total maximum approved credits - \$1,300,000
 - B. Number of investors 21 (11 individuals, 2 foundations/trusts/pension funds, 8 for profit entities)
 - C. Total amount of qualified investments to date - \$1,742,744
 - D. Total amount of credits authorized for this period - \$101,923
 - E. Total amount of credits authorized to date - \$559,025
 - F. Total Investments of \$ 317,742 certified for report period 7/1/08 thru 6/30/09
 - 1. Nature of the business: Bio Tech
Location: Louisville, Kentucky
Investment amount: \$167,742.02
KIFA credits authorized: \$53,807.12

2. Nature of the business: Bio Tech
Location: Louisville, Kentucky
Investment amount: \$150,000
KIFA credits authorized: \$48,116

III. Evermore Investments II, LLC

- A. Total maximum approved credits - \$1,163,672
- B. Number of investors 17 (individuals)
- C. Total amount of qualified investments to date - \$1,397,500.
- D. Total amount of credits authorized for this period - \$130,000
- E. Total amount of credits authorized to date - \$559,000
- F. Total Investments of \$ 325,000 certified for report period 7/1/08 thru 6/30/09

1. Nature of the business: Internet
Location: London, Kentucky
Investment amount: \$125,000
KIFA credits authorized: \$50,000

2. Nature of the business: Software
Location: Louisville, Kentucky
Investment amount: \$200,000
KIFA credits authorized: \$80,000



CABINET FOR ECONOMIC DEVELOPMENT

Steven L. Beshear
Governor

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300 West Broadway
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Larry M. Hayes
Secretary

September 20, 2010

The Honorable Bob Leeper, Senate Co-Chair
The Honorable Rick Rand, Representative Co-Chair
Interim Joint Committee on Appropriations and Revenue
702 Capitol Annex
Room 252
Frankfort, KY 40601

Dear Senator Leeper and Representative Rand:

On behalf of the Kentucky Economic Development Finance Authority, I am submitting the enclosed annual report for the Kentucky Investment Fund Act (KIFA) for the fiscal year beginning July 1, 2009 and ending June 30, 2010. This report is being submitted in accordance with KRS 154.20-264(2).

Please have this report distributed as appropriate.

Please feel free to contact me at (502) 564-4554 should you have questions regarding this information.

Sincerely,

A handwritten signature in black ink that reads "Donna E. Duncan".

Donna E. Duncan, Commissioner
Department of Financial Incentives

c: Gene Fuqua
Catherine Staib
Bobby Sherman

Kentucky Investment Fund Act (KIFA)

Annual Report July 1, 2009 through June 30, 2010

The Kentucky Investment Fund Act (KIFA) provides a 40 percent state tax credit to individuals and corporations that invest in venture capital funds approved by the Kentucky Economic Development Finance Authority (KEDFA) when the approved fund invests in qualifying small Kentucky companies.

This report provides information regarding funds approved under current legislation.

Current Legislation

The allocation of tax credits under the new law began in 2003. As of June 30, 2010, seven venture capital groups have accessed this program receiving an aggregate total of \$6,763,672 in approved credits. One fund reached its maximum amount of allowed credits under the fund's KIFA agreement prior to this reporting period. Two funds received approval for credits authorized during this reporting period totaling \$240,358. One fund did not make an investment in the reporting period but is still active. Three of the seven approved funds failed to meet annual qualified investment requirements over the history of the program and were withdrawn from the program.

Under current law, KEDFA provides a one-time approval for a maximum amount of credits to be authorized for a single fund. Cash contributions are documented at the time of each investment and approved as qualified investments are made. Eligible credits are then prorated among the individual investors based on the amount of individual cash contributions.

The venture capital funds that are active in the program are as follows:

- I. Yearling Fund I, LP –
 - A. Total maximum approved credits - \$1,300,000
 - B. Number of investors: 30 (23 individuals, 6 for-profit entities, 1 non-profit)
 - C. Total investments of \$30,000.20 certified for report period 7/1/09 thru 6/30/10
 - D. Total amount of authorized credits for this period - \$ 10,095
 - E. Total amount of qualified investments to date - \$1,675,178
 - F. Total amount of authorized credits to date - \$563,711
 1. Nature of the business: Internet
Location: Louisville, Kentucky
Investment amount: \$30,000.20
KIFA credits authorized: \$10,095

II. Kentucky Seed Capital I, LP

- A. Total maximum approved credits - \$1,300,000
- B. Number of investors 21 (11 individuals, 2 foundations/trusts/pension funds, 8 for profit entities)
- C. Total investments of \$779,574 certified for period 7/1/09 thru 6/30/10
- D. Total amount of credits authorized for this period - \$250,067
- E. Total amount of qualified investments to date - \$2,522,312
- F. Total amount of credits authorized to date - \$809,092

- 1. Nature of the business: Pharmaceutical
Location: Lexington, Kentucky
Investment amount: \$150,000
KIFA credits authorized: \$48,116
- 2. Nature of the business: Bio Tech
Location: Louisville, Kentucky
Investment amount: \$200,000
KIFA credits authorized: \$64,155
- 3. Nature of the business: Pharmaceutical
Location: Louisville, Kentucky
Investment amount: \$100,000
KIFA credits authorized: \$32,077
- 4. Nature of the business: Medical
Location: Louisville, Kentucky
Investment amount: \$79,574
KIFA credits authorized: \$25,525
- 5. Nature of the business: Bio Tech
Location: Louisville, Kentucky
Investment amount: \$100,000
KIFA credits authorized: \$32,077
- 6. Nature of the business: Bioinformatics
Location: Louisville, Kentucky
Investment amount: \$150,000
KIFA credits authorized: \$48,116

III. Evermore Investments II, LLC

- A. Total maximum approved credits - \$1,163,672.
- B. Number of investors: 14 (individuals)
- C. Amount of qualified investments through June 30, 2010 - \$1,397,500.
- D. Amount of KIFA credits authorized through June 30, 2010 - \$559,000.
- E. Fund is up to date on certification of qualified investments for the current period. Next qualified investment certification due August 26, 2011. Any qualified investment(s) certified by that date will be indicated on the next annual report.

APPENDIX C

KIFA VOLUNTARY SURVEY
PLEASE PRINT

You have or represent a fund or entity which has been identified as an active or potential applicant for or a beneficiary of tax credits pursuant to the Kentucky Investment Fund Act (KRS 154-20.250 et seq.) or you have made inquiries regarding eligibility for these tax credits. The General Assembly has directed the Cabinet for Economic Development to evaluate this program and we are interested in your opinion. We would appreciate disclosure of as much information as you are willing to give including identification of your background and the background of the entity you represent. However, to the extent that confidentiality is important to you or your fund, you may leave blank the specifics that you are not comfortable providing. This survey may be included as part of a report that will be filed with the Kentucky General Assembly and/or its staff, so anything disclosed herein will be subject to public disclosure.

Name: _____

Please specifically identify or as an alternative describe the type of fund or entity which you represent or for whom you are responding:

Have you formally applied for KIFA incentives? If so, please provide the date of your application or applications.

Was your fund or other entity approved for KIFA incentives?

Has the fund benefitted from the incentives and, if so, how [in dollars or general terms]?

Have individual investors benefitted from the incentives and, if so, to what extent [in dollars or other general terms]? (A general description is acceptable if confidentiality is an issue.)

Please describe any difficulties you had with the program requirements or terms.

What are your suggestions for improvements to the program and how would those improvements be beneficial to you as well as other applicants?

Have you or has your fund or entity participated in incentive programs in other states? If so, identify and describe those programs and their benefits.

Comments:

Report to Commonwealth Seed Capital, LLC Board

FUND OVERVIEW

KEDFA has contributed \$20.8 million to CSC since June 2001. As of June 30, 2010, CSC had funded \$14.68 million of its \$19.78 million in committed capital. The following table represents an overview of CSC's investment activity.

CSC Portfolio Summary from Inception through 6-30-10

Investment (Year of Investment)	Commitments (\$ Millions)	Funded to Date	Distributions paid to CSC to Date
<i>Company Investments</i>			
ParkVu (2010)	0.25	0.00	0.00
Intrepid Bioinformatics (2010)	0.13	0.13	0.00
Jacobs Automation (Pending)	0.25	0.00	0.00
IF Technologies (2009)	0.25	0.25	0.00
Advanced Cancer Therapeutics (2009/2010)	0.50	0.50	0.00
Resonant Vibes (2008)	0.25	0.25	0.00
RhinoCyte (2008 / 2009)	0.42	0.42	0.00
Nomad Innovations (2008 / Pending Closing)	0.36	0.25	0.00
OrthoData (2008)	0.25	0.25	0.00
Pradama (2007)	0.25	0.25	0.00
AllTranz (2007 / 2010)	0.50	0.40	0.00
Adaptive Technologies (2007)	0.20	0.20	0.00
Allylix, Inc. (2005)	0.50	0.50	0.00
ApoImmune, Inc. (2005 / 2009)	0.50	0.50	0.00
Ikano (formerly Intranasal) Therapeutics, Inc. (2001/2006/2007)	1.17	1.17	0.00
Planet Biotechnology, Inc. (2004)	0.50	0.50	0.58
Reserve for anticipated additional investments*	1.97	0.00	0.00
Subtotals	<u>\$8.25</u>	<u>\$5.57</u>	<u>\$0.58</u>
<i>Fund Investments</i>			
Bluegrass Angel Venture Fund, II (2010)	1.00	.10	0.00
Triathlon Medical Venture Partners II, LP (pending)	1.00	0.00	0.00
River Cities Capital Funds IV, LP (2008)	2.00	1.06	0.00
Chrysalis Ventures III, LP (2007)	3.00	1.88	0.00
Bluegrass Angel Venture Fund (2005)	1.00	0.86	0.14
Kentucky Seed Capital Fund, LP (2005)	1.00	0.71	0.00
Yearling Fund I, LP (2005)	0.50	0.50	0.10
Chrysalis Ventures II, LP (2002)	2.00	2.00	1.27
River Cities Capital Fund III, LP (2002)	2.00	2.00	1.19
Subtotals	<u>\$13.50</u>	<u>\$9.11</u>	<u>\$2.70</u>
Totals	<u>\$21.75</u>	<u>\$14.68</u>	<u>\$3.28</u>

CSC Investment Fund Activities from Inception through 6-30-10

CSC Commitments		CSC Funded & Unfunded Commitments	
Total Commitments (incl. reserve)	21.75	Commitments Funded to Date	14.68
Less: Reserve for anticipated add'l investments*	(1.97)	Unfunded Commitments	5.10
Subtotal – Commitments minus Reserve	<u>\$19.78</u>	Total	<u>\$19.78</u>
Commitments Funded to Date	14.68		
Total Unfunded Commitments	<u>5.10</u>		

(*)The following reserve amounts are tracked for internal purposes. They are not obligations to invest. \$250k each for Jacobs Automation, IF Technologies, Resonant Vibes, OrthoData, Pradama, and ParkVu; \$200k for Adaptive; \$140k for Nomad Innovations; \$125,000 for Intrepid

(**) CV II retained portions of prior distributions, which are included in the "Funded" and "Distributed" sections.

APPENDIX E

Characteristics of Existing Angel Investment Programs						
	Kentucky	Indiana	North Carolina	Ohio	Virginia	West Virginia
	Kentucky Investment Fund Act (1998)	Venture Capital Investment Tax Credit (2004)	Credit For Qualified Business Investments	Technology Investment Tax Credit	Qualified equity and subordinated debt investments tax credit (1999)	High-growth business investment tax credit (2004)
Tax Credit	40% of investment	20% of investment	25% of investment	25% or 30% of investment	50% of investment	50% of investment
Refundability/ Carry forward	Nonrefundable, carry forward up to 15 yrs	Nonrefundable, Carry forward next 5 years	Nonrefundable, Carry forward next 5 years	Nonrefundable, Carry forward next 15 years	Nonrefundable, carry forward up to 15 yrs	Nonrefundable, carry forward next 4 years
Refundability/ Carry forward	Not more than 50% of total credit granted in any one year	N/A	N/A	N/A	N/A	N/A
Individual investment (credit) limits / caps	not done individually \$8M lifetime cap per <u>fund</u>	\$250,000 (\$50,000 credit) Per year	Pass Through \$750,000 (Individual \$50,000 credit) Per year	\$250,000 or 300,000 per investor in each entity (\$62,500 or 90,000 credit) Per investment	\$100,000 (\$50,000 credit) Per year	\$50,000 (\$25,000 credit) Per year
Business entity limit/ caps		\$500,000 per investor in single business		\$1,500,000 max any one entity		(\$1 million credit)
Program credit limits / caps	\$40M lifetime cap for all funds	\$12.5 million Per year	\$7.5 million Per year	\$45 million lifetime	\$ 5 million Per year	\$ 1 million

	Kentucky	Indiana	North Carolina	Ohio	Virginia	West Virginia
Transferability	Normally Non-transferable, with exceptions	Non-transferable	Non-transferable	Non-transferable	Non-transferable	Transferable
Qualified Businesses Type	Industrial, manufacturing mining, health care, agribusinesses	Motor vehicle racing, Research & Development, tech transfer or any business that brings capital & jobs	Manufacturing warehousing research & development, service related	Research & Development, Tech transfer bio-tech info-tech	Advanced computing, advanced manufacturing, other tech fields, total discretion Va. Sec. of Tech.	Research & Development
Qualified Business Size	Net worth \$5 million or less or net income after federal income tax \$3 million or less or knowledge-based 10 million or less	Average annual revenues \$10 million prior 2 years	Prior year gross revenue \$5 million or less	Last full FY gross revenue less than \$2.5 million or net book value less than \$2.5 million	Annual gross revenues less than \$5 million last tax year	?

APPENDIX F

Characteristics of Existing Angel Investment Programs					
	Hawaii	Kansas			
	High Tech. Business Investment Credit (2001)	Kansas Angel Investor Tax Act (2005)			
Investment Percentage	100%	50%			
Refundability/ Carry forward	Nonrefundable	Nonrefundable, carry forward until all is used			
Credit timeline	Span of five years: 35%, 25%, 20%, 10%, 10%	N/A			
Individual limits / caps	\$2M credit per investor	Annual cap of \$50,000 / individual \$250,000 / business entity			
Business entity limit/ caps					
Program credit limits / caps	year	\$6 million Per year			

	Hawaii	Kansas			
Transferability	2-to-1 transfer for special purpose entities	Can sell credit to a third party			
Qualified Business Type	High-Tech	Bioscience innovative tech preference for animal health companies			
Qualified Business Size	?	Annual gross revenue \$5 million or less most recent tax year			

Increasing Kentucky's Competitiveness: A Proposal for Individual Angel Tax Credits

2010 Kentucky General Assembly



Northern Kentucky Tri-County Economic Development Corporation
300 Buttermilk Pike, Suite 332
P.O. Box 17246
Covington, KY 41017
859-344-0040

1/21/2010
Version 3.1

EXECUTIVE SUMMARY

Increasing Kentucky's Competitiveness: A Proposal for Individual Angel Tax Credits

WHO WILL CREATE KENTUCKY'S FUTURE JOBS?

Since 1980, nearly all net job creation in the U.S. economy has come from firms less than five years old. In addition, in 2007, two-thirds of new jobs came from firms one to five years old. In Kentucky, the Innovation and Commercialization Center (ICC) program has helped entrepreneurs create nearly 3,400 jobs since it began in 2002. As stated in a recent study on job creation – "Entrepreneurs are Key to Job Creation; No Startups, No Job Creation."

ENHANCING ANGEL INVESTMENT IN KENTUCKY

If entrepreneurs are key to job creation and most job creation takes place during the first five years of a startup's existence - What can Kentucky do to stimulate startups and early stage growth? Creating new entrepreneur support programs or adding funding to existing entrepreneur support programs are not feasible given 2010's economic climate and Kentucky's budget issues.

Angel investors help fuel entrepreneurial activity. Kentucky needs more angel investment activity. A modification of the Kentucky Investment Fund Act (KIFA) to increase the number of startups and the growth of early stage companies is needed. Currently, KIFA is not meeting the original legislative intent of increased angel investment activity. Only 14% of the credits have been used in 11 years. In 2009, only 6 investments were made under the program..

Individual angel investors need to have access to the investment tax credits in the KIFA program. This change will make Kentucky competitive with at least 18 other states. This change will increase angel investments in Kentucky's startups and early stage companies. Increased startups and early stage companies will lead to increased jobs in Kentucky.

A MODIFIED KIFA = 5,720 NEW JOBS

Increased angel investments will stimulate the creation of startups, as well as the growth (and survival) of early stage companies. The startups and growing early stage companies are proven to be powerful job creators. Projections estimate that the increased angel investment will lead to the creation of an incremental 5,720 jobs over a ten-year period.

STATE BUDGET IMPACT – A Positive Return on Investment

In addition to the over 5,700 jobs, the overall total financial impact is a 3.5X positive ROI for Kentucky. The \$40M in tax credits will generate a \$139.4M incremental positive financial impact - \$79.4M in incremental income taxes on payroll and \$60M in net incremental investment into the state.

THE PROPOSAL

A change in the current KIFA program to allow individual angels' access to the existing investment tax credits will stimulate angel investing which, in turn, will create over 5,700 jobs in Kentucky over the next ten years. The proposed change makes Kentucky competitive, while also having a positive return on investment for the state budget.

Increasing Kentucky's Competitiveness: A Proposal for Individual Angel Tax Credits

SECTION 1.0 WHO WILL CREATE KENTUCKY'S FUTURE JOBS?

As the chart below shows, since 1980 nearly all net job creation in the U.S. economy has come from firms less than five years old. In most years, without new and young companies, net job creation for the overall economy would be negative.¹

ENTREPRENEURS ARE KEY TO JOB CREATION

No Startups, No Job Creation

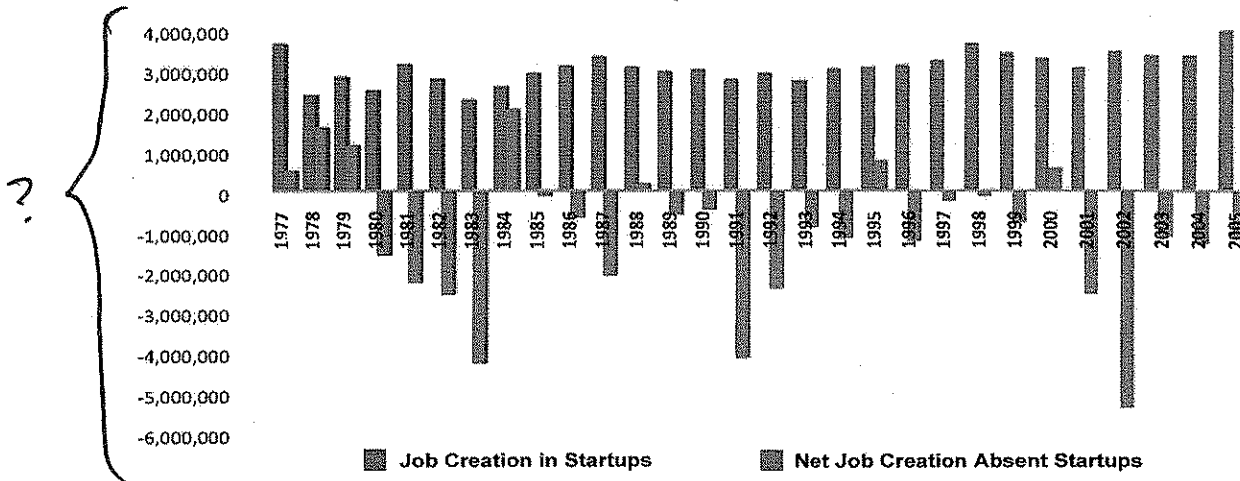


CHART 1

Source: *Business Dynamics Statistics Briefing: Jobs Created from Business Startups in the United States*.
Kauffman Foundation, January 2009.

Today, Kentucky is creating a new generation of entrepreneurs through its education system. A recent study found that four in ten U.S. young people ages 8-21 have or would like to start their own business someday. Sixty-three percent of this group believes they have the skills and ability to successfully start their own businesses.² We teach entrepreneurship at all levels of education – K-12, undergraduate and graduate level. Examples from Kentucky universities include:

- Northern Kentucky University has a nationally recognized Entrepreneurship Institute and offers a major in Entrepreneurship.
- Western Kentucky's Center for Entrepreneurship & Innovation mission is to infuse an entrepreneurial spirit among students, faculty and the community at-large and to stimulate new venture development.
- In addition to establishing the Forcht Center for Entrepreneurship in 2008, the University of Louisville offers a PhD in entrepreneurship.
- The University of Kentucky demonstrates its commitment to entrepreneurship by stating – "The Von Allmen Center for Entrepreneurship is the nexus for business development at the University of Kentucky."

Young Firms Account for the Most Jobs and the Highest Average Number of Jobs Created

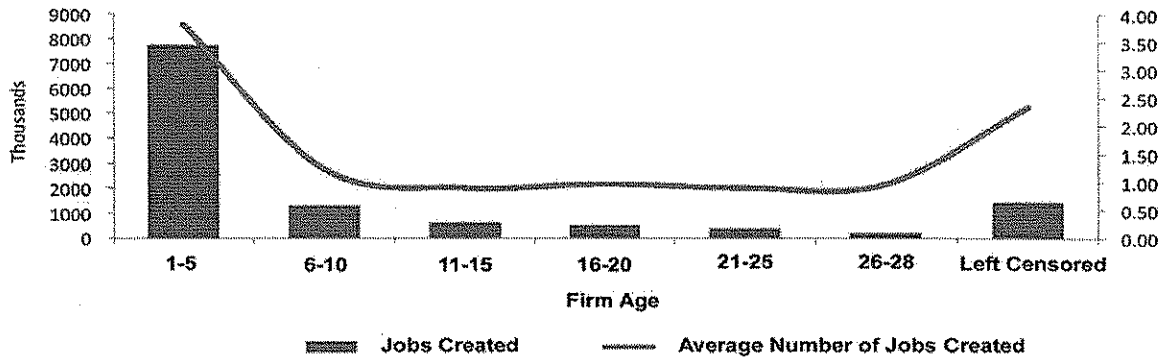


CHART 2

Source: *Where will the Jobs Come From?* Kauffman Foundation, November 2009

In addition to the fact that entrepreneurs account for all the recent net new job creation, using Census Bureau data the Kauffman Foundation found that in 2007, companies in existence for 1-5 years accounted for roughly two-thirds (approximately 8 million) of overall jobs created. This data showed that while the largest share of employment remained in the oldest and largest companies (the “left censored” category), young companies in existence from 1-5 years were adding significant amounts of new jobs to the economy. Finally, the data revealed that companies in existence 1-5 years also created the highest average number of jobs - roughly four jobs per year.³

1.1 Entrepreneurs Create Jobs in Kentucky

The data in Chart 3 is the result of Kentucky’s Innovation and Commercialization Center (ICC) program. The Cabinet for Economic Development’s Department of Commercialization and Innovation program began supporting technology-based entrepreneurs and early stage companies in 2002. The ICC program has helped entrepreneurs create nearly 3,400 jobs since it began in 2002. In fiscal 2009, the program operated with a \$2.1M budget and generated \$9.8M in incremental income tax revenue for Kentucky.⁴

ICC Performance Results 2002-2009

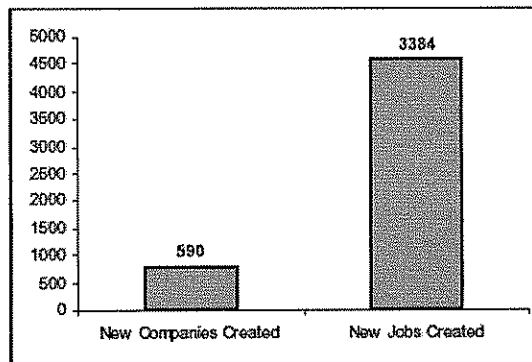


CHART 3

Source: Kentucky Science & Technology Corporation. *Annual Report to Department of Commercialization and Innovation, Kentucky Economic Development Cabinet, August 1, 2009*

SECTION 2.0 JOB CREATION IN KENTUCKY – Using an Existing Program

While Kentucky must encourage startups, we must also keep the startups alive and stimulate early stage growth during startups' first five years of existence. It is during this period that jobs are created.⁵

Ideally, Kentucky could create new entrepreneur support programs or add funding to existing entrepreneur support programs, both of which would lead to job creation, yet they are not feasible given 2010's economic climate and Kentucky's budget issues.

The existing Kentucky Investment Fund Act program (KIFA) can be modified to allow individual angels (versus requiring a formal fund) to obtain the investment tax credit. This modification will stimulate the creation of startups and also increase the survival and growth of early stage companies. The end result will be increased job creation.

2.1 Using KIFA to Increase Angel Investments in Kentucky

Angel investors are individuals with high net worth who, either alone or within a group, provide their own money as investment capital to entrepreneurs, usually at the seed and early stages. Angel investments typically target sectors with high growth potential, such as biotechnology, life sciences, research and information technology.

Whereas traditional venture capitalists have become increasingly cautious, angel investors are willing to engage in high-risk investments in hopes of higher returns. In addition to financial investment, "angels" often provide consulting advice, business expertise and additional connections to help fledgling companies grow.

And unlike formal venture capitalists, who often demand startups to relocate to entrepreneurial "hot spots," angel investors typically support local and regional business activity.⁶

Angel investors play a critical role in this process by providing both capital and guidance to the entrepreneurs.⁷ In addition to the job creation cited in Section I, a recent study by the Center for Venture Research concludes that angel investments are a significant job growth driver. The study found that in 2007, angel investments created 200,000 new jobs in the United States or about 3.3 jobs per angel investment.⁸ The report noted that these numbers are likely understated as the jobs were only tracked at the time of the angel investment and did not track post-investment job creation. The salaries of the high-tech jobs created by companies, assisted by the aforementioned Kentucky ICC program, average over \$65,000.⁹ Robust angel investment activity in Kentucky will drive growth in jobs that can even exceed \$65,000 in average annual salary.

2.2 The Importance of Angel Investment – Bridging the Valley of Death

From "day one," early-stage entrepreneurial companies' risk being victims of this so-called Valley of Death. If the company, or its founders, does not secure adequate funds to cover negative net cash flow in the months and/or years of business creation and growth, they face the likelihood of going out of business.¹⁰

Stages/Funding of Start-Ups

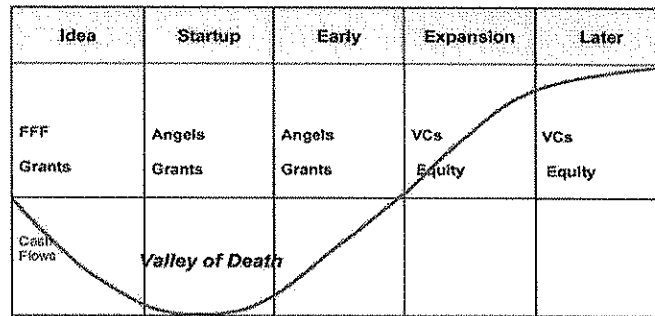


CHART 4

Source: ezone Client Education Document, 2009

The Valley of Death is best described as the lack of investment capital available from sources outside of the three Fs (Friends, Family & Founders) and government grant support. This Valley is due to a period of negative cash flows, causing many startups to fail. This negative cash flow period increases the already high risk of investing in a startup or early stage company. Angel investors are the most likely source of investments at this entrepreneurial growth stage. Angel investors use their financial wealth and experience to help these new entrepreneurial firms grow.¹¹

If Kentucky is able to increase angel investments to assist companies in crossing The Valley of Death, the following will occur:

- An increase in out-of-state startups and early stage companies' relocations will occur as Kentucky will become known regionally and nationally for its vibrant angel stage investment activity;
- An increase in in-state startups will occur due to the reduction of risk at the Valley of Death stage; and
- A greater number of Kentucky startups and early stage companies will have a better chance at succeeding due to adequate funding.

The end result of increased angel investing is increased job creation.

2.3 Increasing Angel Investments – National trends

Nationally, many states have taken a number of approaches to stimulate angel investment activities. These include:

- Promote education seminars for current and potential angel investors;
- Assist in the creation of statewide angel group networks;
- Ensure that angel investors are well represented on economic development boards;
- Collect data to monitor the impact on policies that encourage angel investments;
- Co-invest in regional angel funds; and
- Provide tax credits for angel investments.¹² (emphasis added)

In 2000, the Kentucky General Assembly implemented a number of the state strategies in House Bill 572 – the Kentucky Innovation Act. These strategies are primarily developed and implemented through the Cabinet for Economic Development's Department of Commercialization and Innovation.

2.4 Increasing Angel Investment via State Tax Credits

Angel investment tax credit programs have two general types of programs regarding who may access the tax credits – Individual Angels or Investment Funds. Across the U.S.:

State	Individual Angels	Investment Fund	Individual Angels or Investment Fund
Arkansas	X		
Arizona	X		
Hawaii	X		
Indiana	X		
Iowa		x	
Kansas	X		
Kentucky		x	
Louisiana	X		
Maine	X		
New Jersey	X		
New Mexico	X		
New York	X		
North Carolina	X		
North Dakota	X	x	x
Ohio	X		
Oklahoma	X		
Oregon		x	
Vermont	X		
Virginia	X		
West Virginia	X		
Wisconsin	X	x	X
Total	18	5	2

Individual Angel Tax Credits – The general format of this model is used by 18 states and it is very simple for the company and the angel investor. A company applies to the state to be qualified for the tax credit program. An angel investor making an investment in a qualified company is then granted a state income tax credit for X% of the investment. The exact tax credit rate varies from state to state (for example -100% in Hawaii down to 10% in New Jersey and Vermont).

Investment Fund Tax Credits – This category is used by five states, including Kentucky. In this format, a qualified investment fund makes the equity investment in the qualified company. The fund makes an application to the state for the tax credit and distributes the credits to its investors. Tax credit rates vary from state to state (for example - Kentucky's tax credit rate is 40%).

Note: Two states allow both Individual Angel and Investment Fund access to the tax credits.

2.5 Illinois Governor Calls for Individual Angel Tax Credits

In December 2009, Illinois Governor Pat Quinn released his Illinois Economic Recovery Plan – Jobs for Today and Tomorrow. The plan calls for implementing an individual angel investment tax credit program similar to the program we are proposing for Kentucky. His plan specifically cites Wisconsin and North Carolina's successful individual angel tax credit programs:

Small businesses have a critical role in driving job creation and innovation. However, the growth of new technology businesses in Illinois is hurt by not having access to seed and early stage capital. The creation of the Angel Investment Tax Credit program for state-registered and qualified early-stage venture capitalists or angel investors will fill that gap. This program will allow investors making an early-stage investment in a technology startup to receive a capped credit against his or her Illinois tax bill. A similar program is now in place in Wisconsin where for every one dollar in state tax credits provided to investors, there has been at least four dollars in private investment. Between 1999 and June 2007, North Carolina's program resulted in \$1.72 billion of new investment into the state, 35 times the state's initial investment of \$48.5 million.¹³

SECTION 3.0 KENTUCKY'S CURRENT ANGEL TAX CREDIT PROGRAM IS NOT WORKING AS ORIGINALLY INTENDED

The Kentucky legislature created the Kentucky Investment Fund Act (KIFA) in 1998. From 1998 to 2002, only one fund used the program for a total of three investments. In recognition of the economic development benefits of angel investing and in an effort to stimulate angel investing, the legislature modified Kentucky's Investment Fund Act (KIFA) in 2002. Kentucky chose to award tax credits to investment funds versus directly to individual angels. In recognition of the importance of stimulating angel investing, the legislature provided significant funding to KIFA - "... The total tax credits available for all investors in all investment funds shall not exceed forty million dollars (\$40,000,000)."¹⁴

The 2009 Kentucky Economic Development Finance Authority (KEDFA) report on KIFA¹⁵ reports on the program as follows:

- Only three funds used the program in fiscal 2009;
- Only 6 investments were made under the program in 2009; and
- Most importantly, of the \$40,000,000 provided by the legislature to stimulate statewide angel investing (and job creation), only \$6.7M (14%) of authorized credits have been used in 11 years.

The ineffectiveness of the KIFA program can be seen in the chart below that compares the results for Kentucky's and Ohio's programs. It is important to note that Ohio uses the proposed individual angel tax credits format. In addition, it is important to note that Ohio's program is much more restrictive in what industry category the companies resides in. Ohio's program is restricted to companies in the high tech sector.

Angel Investment Tax Credit Programs

(all \$ in millions)

	Ohio	Kentucky
Year Created	1996	1998
Total Credits in Program	\$30	\$40
Industry Limits	Yes	Some
Model	Individual	Fund
Tax Credit Percentage	25% or 30%	40%
Companies Approved (since inception)	442	?
Tax Credits Approved (since inception)	\$26.1	\$6.7
Private Investment in State (since inception, due to credit)	\$109.8	\$16.8
2009 Companies Approved for Funding (new to program)	72	6
2009 Investments - Companies Receiving Investment	234	6
2009 Private Investment in State (due to credit)	\$11.9	\$0.7
2009 Tax Credits Approved	\$2.9	\$0.3
2008 Companies Approved for Funding (new to program)	66	14

CHART 5

Source: Cabinet for Economic Development, Department of Financial Incentives, Kentucky Investment Fund Act (KIFA) Annual Report, October 2008 and October 2009; SRI International, Making an Impact: Assessing the Benefits of Ohio's Investment in Technology-Based Economic Development Program, September 2009; Ohio Department of Development, Ohio Economic Development Incentive Study, May 4, 2009.

In conclusion, KIFA in its current form is not stimulating the desired robust statewide extensive angel investment activity that was anticipated upon enactment of the investment fund tax credit format.

3.1 Making KIFA Successful

Legislators simply need to provide KIFA with an option to access the investment tax credits via individual angel investors. The individual angel investor would receive a personal income tax credit of 40% of their investment. This individual angel access would be in addition to the current investment fund access. This addition will provide a much needed stimulus for angel investing throughout Kentucky. Tony Shipley, founder of the nationally recognized Queen City Angels based in Cincinnati, emphatically states:

“The Ohio individual angel tax credit is an absolutely essential ingredient in getting our angel investors on board and doing deals.”

Bob Frey, a Kentucky resident, a member of the Queen City Angels and an angel investor who has made investments in over 20 startups and early stage companies, states:

“I live in Kentucky but do my angel investing in Ohio because of Ohio’s investment tax credit. Sure, if Kentucky offered an investment tax credit I would invest in Kentucky.”

3.2 A Successful KIFA – A Job Creation Engine

The **Annual Net Job Creation Projection Under Proposed Modified KIFA** chart below is from the in-depth analysis that is presented in full in the accompanying Appendix. The assumptions for the analysis in the Appendix were made using results from the 2009 ICC program¹⁶, angel investment industry results data¹⁷ and other assumptions listed in the Appendix.

A modified KIFA would be a job creation engine that would create over 5,700 incremental net new jobs over ten years. Significantly more jobs would have actually been created by the KIFA modification, but companies funded by angel investments are high risk and, therefore, the analysis factors in the loss of a number of the jobs due to companies going out of business in their first three years. For example, the analysis assumes that an industry standard 50% of the angel-backed companies will go out of business in the first three years of their existence..

**Annual Net Job Creation Projection
Under Proposed Modified KIFA**

Year	1	2	3	4	5	6	7	8	9	10
New Net Jobs Year 1	147	92	150	0	61	80	106	139	183	240
New Net Jobs Year 2		147	92	150	0	61	80	106	139	183
New Net Jobs Year 3			147	92	150	0	61	80	106	139
New Net Jobs Year 4				147	92	150	0	61	80	106
New Net Jobs Year 5					147	92	150	0	61	80
New Net Jobs Year 6						147	92	150	0	61
New Net Jobs Year 7							147	92	150	0
New Net Jobs Year 8								147	92	150
New Net Jobs Year 9									147	92
New Net Jobs Year 10										147
Total Jobs	147	239	390	390	451	531	637	776	959	1,199
TOTAL										5,720

CHART 6

Source: See Appendix: Incremental Income Tax Revenue and Jobs Created with Modified KIFA

3.3 State Budget Impact – A Positive Return on Investment

In addition to the creation of over 5,700 net new jobs, this modification in KIFA would also have a 3.5X positive financial ROI for the state.

It is estimated that the change in legislation will generate approximately \$10M in incremental investments in startups and early stage companies in Kentucky.

Year	1	2	3	4	5	6	7	8	9	10	Total
New Investment by Angel Investors	10	10	10	10	10	10	10	10	10	10	\$100M
Tax Credits to Angel Investors	4	4	4	4	4	4	4	4	4	4	\$40M
Net Incremental Investment into State	6	6	6	6	6	6	6	6	6	6	\$60M

An in-depth analysis (see Appendix) was performed using data from last year's ICC program¹⁸ and general angel investment results data¹⁹ and it is projected that the incremental \$10M in investments will generate incremental jobs that in turn will generate incremental income tax revenues. [Notes: (1) Other business taxes are not factored in the incremental tax generated amount; (2) Economic multipliers are not factored into the incremental tax generated amount.]

Year	1	2	3	4	5	6	7	8	9	10	Total
Incremental Income Tax Revenue	0.55	1.5	3.1	4.0	5.2	6.8	9.0	12.0	16.0	21.4	\$79.4M

The combined incremental financial impact for the state: Net incremental Investment + Incremental Income Tax Revenue.

Year	1	2	3	4	5	6	7	8	9	10	Total
Net New Investment Into State	6	6	6	6	6	6	6	6	6	6	\$60M
Incremental Income Tax Revenue	0.55	1.5	3.1	4.0	5.2	6.8	9.0	12.0	16.0	21.4	\$79.4M
Total Net Financial Impact on State	6.55	7.5	9.1	10.0	11.2	12.8	15.0	18.0	22.0	27.4	\$139.4M

In summary, the financial return on investment for the state is significant.

- Direct ROI – The increased jobs from the tax credits would generate \$79.4M in incremental state income tax revenue over the next ten years;
- Indirect ROI – The investment stimulated by the tax credits would also put an incremental \$60M at work in the Kentucky economy.
- Direct + Indirect ROI = \$139.4M

The overall total financial impact is a 3.5X positive ROI for Kentucky.

3.4 Other Concerns - Cabinet Staff Workload Impact

The current form of KIFA requires an initial screening and qualification of both the investment fund and the proposed company. Thereafter, the staff must review and re-qualify each fund and company that was awarded the credit on an annual basis.

The proposed modified KIFA would use Ohio as a model. The Ohio Department of Development outlines the complete process on their website using a one page document (see ATTACHMENT).

http://www.odod.state.oh.us/cms/uploadedfiles/Root/Quick_Navigation/OTITC%20Process.pdf

The Ohio model removes the requirement of tracking and re-qualifying each investor and company annually. In addition, the proposed modified KIFA legislation would require the local ICC office to market the tax credits, provide formal applications to applicants, counsel applicants and accept application submissions (Ohio uses their Edison Centers to perform a similar function). This would be a welcome addition to the ICC workload as it would further the mission of the program – Job Creation in Kentucky.

In summary, an up-tick in the number of KIFA angel tax credit applications should be expected and this will lead to incremental applications needing review. The review would be a one-time event given the proposed elimination of the ongoing annual review and re-qualification.

The increased workload on Cabinet staff is anticipated to be minimal once the program is up and running.

SECTION 4.0 CONCLUSION

A minimal change in the current KIFA program to allow individual angels' access to the existing investment tax credits will stimulate angel investing, which in turn will create over 5,700 jobs in Kentucky. The proposed change also has a significant positive return on investment for the state budget.

The following organizations have reviewed and support this proposal:

- Northern Kentucky Tri-County Economic Development Corporation
- Northern Kentucky Chamber of Commerce
- Kentucky Science and Technology Corporation, Lexington

APPENDIX

Incremental Income Tax Revenue and Jobs Created with Modified KIFA

Assumptions:

What percent of the ICC companies that have been created would be angel funded	25%	
New Jobs created statewide per the FY09 annual ICC report to DCI	660	
Jobs from angel funded companies	165	
Incremental jobs due to angel funding of ICC companies (1.5X)	83	
Companies attracted from out of state due to investment credit	8	
Average employees at investment	8	
Incremental jobs from out of state	64	
Total Incremental Jobs (ICC increase and Out of State Companies)	147	
What percent of these angel funded companies failed after 3 years (strikeouts)	50.0%	50% Surviving Jobs
What percent of these angel funded companies job growth was 10% per year (singles)	20.0%	110% Growth
What percent of these angel funded companies job growth was 30% per year (triples)	20.0%	130% Growth
What percent of these angel funded companies job growth was 50% per year (home runs)	10.0%	150% Growth
Growth slows significantly after year 4	50.0%	
Average salary of the high tech jobs created per the FY09 annual ICC report to DCI	Avg. Salary \$ 64,928.0	3% Increase
Average income tax rate for the state	Tax 5.80%	

Incremental Income Tax Revenue

Year	1	2	3	4	5	6	7	8	9	10
Net Jobs Subject to Income Tax - Year 1	147	239	389	194	255	336	441	581	763	1,004
Net Jobs Subject to Income Tax - Year 2		147	239	389	194	255	336	441	581	763
Net Jobs Subject to Income Tax - Year 3			147	239	389	194	255	336	441	581
Net Jobs Subject to Income Tax - Year 4				147	239	389	194	255	336	441
Net Jobs Subject to Income Tax - Year 5					147	239	389	194	255	336
Net Jobs Subject to Income Tax - Year 6						147	239	389	194	255
Net Jobs Subject to Income Tax - Year 7							147	239	389	194
Net Jobs Subject to Income Tax - Year 8								147	239	389
Net Jobs Subject to Income Tax - Year 9									147	239
Net Jobs Subject to Income Tax - Year 10										147
Total Jobs Subject to Income Tax	147	385	775	969	1,224	1,560	2,001	2,582	3,345	4,349
Total Salaries Paid	\$ 9,511,952	\$ 25,766,927	\$ 53,351,323	\$ 68,726,037	\$ 89,444,248	\$ 117,396,777	\$ 155,144,550	\$ 206,156,116	\$ 275,129,349	\$ 368,427,181
Estimated State Tax Rev.	\$ 551,693	\$ 1,494,482	\$ 3,094,377	\$ 3,986,410	\$ 5,187,766	\$ 6,809,013	\$ 8,998,384	\$ 11,957,055	\$ 16,957,502	\$ 21,368,777

10YR TOTAL REVENUE: \$ 79,465,159

Incremental Job Creation

Year	1	2	3	4	5	6	7	8	9	10
New Net Jobs Year 1	147	92	150	0	61	80	106	139	183	240
New Net Jobs Year 2		147	92	150	0	61	80	106	139	183
New Net Jobs Year 3			147	92	150	0	61	80	106	139
New Net Jobs Year 4				147	92	150	0	61	80	106
New Net Jobs Year 5					147	92	150	0	61	80
New Net Jobs Year 6						147	92	150	0	61
New Net Jobs Year 7							147	92	150	0
New Net Jobs Year 8								147	92	150
New Net Jobs Year 9									147	92
New Net Jobs Year 10										147
Total Jobs	147	239	390	390	451	531	637	776	959	1,199
										TOTAL 5,720

Source: Northern Kentucky Tri-County Economic Development Corporation, Barach, Casey; January 2010

APPENDIX H

NORTH CAROLINA DEPARTMENT OF REVENUE

Qualified Business Investment Tax Credit Program--December 31, 2009

APPLICATIONS FILED			AMOUNT OF INVESTMENT			AMOUNT OF CREDIT					
Year of Investment	Individuals	Corporations/ Pass-throughs	Individuals	Corporations/ Pass-throughs	Total	Year credit claimed	Credits Applied For	Individuals	Corporations/ Pass-throughs	Total Credits Allowed	
1988	71	0	4,530,530	-	4,530,530	1988	1,028,882	1,028,882	+	1,028,882	
1989	90	33	3,136,940	2,257,375	5,394,315	1989	1,348,580	784,235	+	1,348,580	
1990	252	32	9,316,804	2,497,700	11,814,504	1990	2,894,817	2,270,392	+	2,894,817	
1991	254	30	13,315,323	2,427,220	15,742,543	1991	3,934,332	3,327,527	+	3,934,332	
1992	274	29	17,411,578	2,356,215	19,767,793	1992	4,711,913	4,122,857	+	4,711,913	
1993	438	5	44,842,801	22,975	44,865,776	1993	6,011,513	6,005,769	+	6,011,513	
1994	291	17	9,495,987	5,958,898	15,454,885	1994	3,523,894	2,285,651	+	3,523,894	
1995	347	17	10,633,265	10,214,891	20,848,156	1995	4,677,221	2,583,748	+	4,677,221	
1996	475	45	15,222,894	24,575,538	39,798,432	1996	9,230,769	2,322,317	+	6,000,000	
1997	599	38	17,211,861	6,585,474	23,797,335	1997	5,344,641	4,235,771	+	5,344,641	
1998	421	43	22,271,454	5,997,644	28,269,098	1998	6,451,613	4,714,892	+	6,000,000	
1999	400	54	22,472,845	10,065,587	32,538,432	1999	7,058,823	4,221,732	+	6,000,000	
2000	832	143	53,638,701	33,673,365	87,312,066	2000	18,750,000	3,612,777	+	6,000,000	
2001	512	97	29,031,706	10,287,946	39,319,652	2001	7,792,208	4,179,918	+	6,000,000	
2002	488	102	20,671,206	8,933,595	29,604,801	2002	5,595,113	4,064,764	+	5,595,113	
2003	524	86	19,480,593	10,601,226	30,081,819	2003	6,896,552	3,093,653	+	6,000,000	
2004	514	98	18,069,083	8,721,318	26,790,401	2004	5,889,109	4,140,597	+	5,889,109	
2005	535	90	22,060,420	14,486,270	36,546,690	2005	7,878,069	4,396,524	+	7,000,000	
2006	514	72	25,316,631	7,194,390	32,511,021	2006	6,549,418	5,183,653	+	6,549,418	
2007	605	101	44,778,774	17,076,048	61,854,822	2007	9,435,493	6,755,892	+	7,000,000	
2008	403	60	25,499,862	4,188,723	29,688,585	2008	4,983,538	3,940,754	+	4,983,538	
Total Applications	8839	1192	448,409,257	188,122,398	636,531,655	Total Credits	129,986,498	77,272,205	+	31,656,228	106,492,971

Note: Effective for investments on or after January 1, 1996, G.S. 105-163.012 limits the total tax credits that can be claimed for the tax year to \$6,000,000. Effective for investments on or after January 1, 2004, G.S. 150-163.012 limits the total tax credits that can be claimed for the tax year to \$7,000,000. Effective for investments made on or after January 1, 2008, G.S. 105-163.012 limits the total tax credits that can be claimed for the tax year to \$7,500,000. The threshold has been exceeded in six of the last ten years. Therefore, the credit claimed by each taxpayer for the respective year was reduced by the following percentages which have been rounded to the nearest whole number.

- 35% - 1997
- 7% - 1999
- 15% - 2000
- 68% - 2001
- 23% - 2002
- 13% - 2004
- 9% - 2006

Effective for investments made on or after January 1, 1997, the credit is allowed only to individuals or individual partners, shareholders, or members of pass-through entities.

**The Impact of the High Technology
Business Investment Tax Credit on
Hawaii's Economy for Calendar
Year 2008**

**Department of Taxation
State of Hawaii
December 2009**

Web Site: www.hawaii.gov/tax

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I. EXECUTIVE SUMMARY

On June 21, 2007, House Bill 1631 was signed into law as Act 206 (the "Act"). The purpose of the Act is to measure the effectiveness of the high technology business investment tax credit (investment credit) established by Act 178 of 1999, as amended by Act 221 of 2001 and Act 215 of 2004.

Act 206 requires a qualified high technology business (QHTB) that accepts an investment for which a State investment credit may be claimed, to complete and file an annual electronic survey prepared by the Department of Taxation (Department). The survey must be filed on or before June 30 of each year for the five years following the year of the investment.

The Act also requires the Department to take two actions with the data obtained from this survey. First, the Department is required to compile the information in the survey, tax returns, and related documents and submit that information for review to the Legislature. This was completed on September 1, 2009. Second, the Act asks the Department to study the effectiveness of the investment credit and to issue a report on its findings. This report responds to this requirement.

The Act applied to QHTBs who received investments after June 30, 2007. It required these QHTBs to report on investments received between calendar year 2000 and 2008. A total of 203 QHTBs filed the survey this year, including 23 firms that filed after the reporting deadline and were not included in the compilation submitted to the Legislature on September 1, 2009.

This December 2009 report analyzes the following four questions: 1) what is the size of the investment made in QHTBs since the passage of Act 178 in 1999; 2) how much in State tax credits was granted to attract this investment; 3) what type of jobs and how many jobs were created as a result of these investments; and 4) are these investments creating viable companies with the ability to contribute on an on-going basis to the economic diversification of the State.

The findings for these key questions include:

1. Total Investment. The 203 QHTBs that filed reported receiving a total of \$1.369 billion in cash investments between calendar year 2000 and 2008.
2. Tax Credit Costs. The cumulative cost of State tax credits through 2008 is estimated to be \$775.9 million for investments made in QHTBs. However, the total possible additional credits that could be claimed by investors in these companies is \$593.0 million. The State remains obligated to honor these tax credit claims, thus reducing the State's potential revenues over at least the next four years.
3. Number and Types of Jobs. The 203 QHTBs reported creating 1,619 jobs, of which 1,450 were full-time positions. These firms also employed a total of 242 temporary workers and 2,840 independent contractors.
4. Viability of the Companies. The 203 QHTBs reported that their expenses were considerably higher than their revenues (\$378.2 million in expenses; \$207.7 million in revenues). Fifty-seven firms have been in business for six years or more. Only 59 companies had revenues greater than expenses in 2008. The majority of these QHTB companies did not pay corporate income taxes in Hawaii and reported paying only \$2.1 million in GET taxes to Hawaii in 2008.

It should be noted that the analysis contained in this report does not reflect the effects of Act 178 of 2009 which did not take effect until May 1, 2009. That Act established an 80% tax credit cap on entities claiming a 221 tax credit on their tax returns, disallowed certain tax credit carryover provisions for investments made on or after May 1, 2009 through December 31, 2010, and limited the credits to a 1 to 1 ratio for investments made after May 1st. The fiscal and programmatic impacts of Act 178 will start to occur in the data that is collected next year.

II. LEGISLATIVE HISTORY

In 1999 the Hawaii State Legislature passed Act 178 that encouraged Hawaii taxpayers to invest in high technology companies by granting a credit against taxes owed the State. Act 178 limited the amount of the tax credit to 10% of the investment, with a maximum allowable credit of \$500,000 per year.

Act 178 also encouraged taxpayers to invest in research activities by establishing a separate "research activities" tax credit. The research might be conducted by a high technology company or a non-technology firm engaged in a research project. The amount of the credit was limited to 2.5% of the expenses incurred by the firm to actually conduct new research over and above the research the company was already doing (called a base amount). The research credit was nonrefundable and could only be utilized against tax liability; any excess was carried forward until exhausted.

In 2001 Act 221 amended the 1999 law and allowed taxpayers to claim 100% of their investment in a high technology firm, permitting the taxpayers to claim 35% of the amount in the first year, 25% in the second year, 20% in the third year, and 10% in the fourth and fifth tax years after their initial investment. This bill revised the maximum allowable credit to \$700,000 in the first year, with declining amounts in the subsequent four years.

Act 221 also changed the research activities tax credit by deleting the reference to a base amount of research the company was already doing and allowed expenses in any research being done in the State of Hawaii to qualify for the research tax credit. Significantly, the research

credit was refundable.¹ The amount of research tax credit that can be claimed each year was equal to 20% of the company's research expenditures.

In 2004 the original statute was further amended by Act 215 to place a cap on the ratio of credits a taxpayer could claim for a high technology tax investment. If a taxpayer was claiming \$1.50 in credits for \$1.00 invested in a technology firm, then the tax claim would likely not be reviewed by the Department of Taxation. If the taxpayer claimed a higher amount (such as \$2.00 in credits for each \$1 invested), this Act stated that those investments would be subject to review by the Department of Taxation.

Act 215 also changed the research activities tax credit by limiting it to only qualified high technology businesses, effective July 1, 2004.

In 2009 the Legislature further amended Act 178 and Act 221 by limiting the fiscal impacts of the credits for the period between May 1, 2009 and December 31, 2010 when Act 221 is scheduled to expire. Act 178 of 2009 limited the use of the investment tax credit to 80% of the tax liability of the filer for taxable years beginning on January 1, 2009 and ending December 31, 2010. The Act also disallowed certain tax credit carryover provisions for investments made between May 1, 2009 and the date Act 221 expires. Finally, this newest legislation limited the credits to no more than a 1 to 1 ratio for investments made after May 1, 2009.

This report was prepared pursuant to Act 206, Session Laws of Hawaii (SLH) 2007. The purpose of this Act is to measure the effectiveness of Act 178/221 high technology business investment tax credits, as amended, by requiring:

"(1) Qualified high technology businesses receiving an investment for which a credit may be

¹ Pursuant to Act 297, Session Laws of Hawaii (SLH) 2000, the research credit was made refundable. A refundable credit is paid to a taxpayer even if the taxpayer has no tax liability, or is first offset against tax liability with any excess refunded to the taxpayer. However, Act 297 only allowed a refundable credit of 2.5% of the qualifying Hawaii research expenses over and above the research the company was already doing (i.e., base period).

claimed under Section 235-110.9, Hawaii Revised Statutes, to submit investment, employment, job creation, wage, revenue, expense, and other information to the department of taxation;

- (2) The department of taxation to annually report this information in aggregate form to the legislature; and*
- (3) The department of taxation to use the information to study the effectiveness of the tax credit and report the department's findings to the legislature.”*

In September 2009 the Department of Taxation reported on (1) the amounts invested in the qualified high technology businesses (QHTBs), (2) the number of QHTBs in each industry sector, (3) the salaries/wages the QHTBs paid to their employees, and (4) the activities the QHTBs performed.² The study conducted for this report utilized data from the September 2009 report, data from 23 companies who filed after the reporting deadline, and aggregate tax return data available to the Department of Taxation.

III. BACKGROUND ON THE HIGH TECHNOLOGY BUSINESS INVESTMENT TAX CREDIT AND THE RESEARCH ACTIVITIES TAX CREDIT

The investment credit is a nonrefundable credit claimed by persons investing in QHTBs who owe Hawaii State taxes in one of three categories: Hawaii income taxes (§235-110.9, HRS), Hawaii franchise taxes (§241-4.8, HRS), and Hawaii insurance premiums taxes (§431.7-209, HRS). In its present form, investors may claim 100% of their qualifying cash investments, up to a maximum of \$2 million per QHTB. The tax credits can be claimed over a five year period. The credit is computed as a percentage of the cash investment made: 35% in the year the investment is made, 25% in the second year, 20% in the third year, and 10% in both

² See the report *Descriptive Statistics on the Operations of Qualified High Technology Businesses From 2002 Through 2008*, Department of Taxation, State of Hawaii, September 2009.

the fourth and fifth years. Because it is a nonrefundable credit, the amount of the allowable credit used cannot exceed the taxpayer's tax liability for that year. However, any excess unused credit may be carried forward to future years until it is used in its entirety, unless the investment was made on or after May 1, 2009.

The research activities tax credit is a refundable credit. Refundable means the amount of the allowable credit used can exceed the amount of taxes owed by the QHTB for that year. As stated earlier, the credit equals 20% of the QHTB's qualified research expenditures in Hawaii.

In enacting these two tax credit programs, the Legislature stated that the primary purpose of the legislation was to "encourage the continued growth and development of high technology businesses and associate industries" in Hawaii.

IV. DATA SOURCES

Each year qualified high technology businesses are required to file Department of Taxation Form N-317, "Statement by Qualified High Technology Business." The QHTBs are asked to provide data for the previous calendar year. The deadline to file is June 30th of each year. QHTBs began filing the N-317 form for calendar year 2002 operations. The form was significantly improved for the calendar year 2007 reporting period to include more detail on the operations of high technology firms qualifying for tax credit investments. The form was slightly amended for the calendar year 2008 reporting period to capture data on general excise taxes paid by QHTBs.

As shown in Table 1, a total of 371 QHTBs have filed Form N-317 since the form was introduced for the 2002 reporting period. Of these, 48% specified that their qualifying activity was computer software development, 16.3% specified performing arts activities, 15.2% specified multiple activities, 8.7% stated they were involved in biotechnology activities, and 5.9% were involved in non-fossil fuel energy-related technology activities.

Table 1. Cash Investment Received by 203 QHTBs, by Year (2008 Filers)

Activity	Number of QHTBs Filing N-317		Cash Investment	
	2002 - 2008	2008	2000 - 2008	2008
Research as in IRC Sec. 41(d)	26	15	\$101,803,777	\$15,360,136
Biotechnology	30	18	\$104,119,360	\$17,606,665
Computer Software	110	45	\$164,605,597	\$31,771,352
Non-fossil Fuel Energy	28	20	\$119,150,944	\$50,234,044
Performing Arts	86	50	\$528,562,032	\$111,806,886
Multiple Activities & Others	91	55	\$350,613,843	\$38,911,911
TOTAL	371	203	\$1,368,855,553	\$265,690,994

V. INVESTMENT IN HAWAII

The 203 qualified high technology businesses who filed the 2008 N-317 form this year reported receiving nearly \$1.4 billion in cash investments from calendar years 2000 through 2008. Almost \$266 million in investments occurred in 2008 alone.

QHTBs involved in performing arts received 38.6% of the total funds invested over the nine year period covered in the Table 1 data, a cumulative total of \$528.6 million. Performing arts entities have received the lion's share of Act 221 investments since 2004, in part because the ability to recoup one's investment in these types of activities occurs over a shorter period of time. QHTBs reporting that they were involved in multiple high technology activities received 25.6% of the investments (\$350.6 million). Computer software firms received investments totaling \$164.6 million, or 12.0% of the total. Companies engaged in biotechnology received \$104.1 million, 9.0% of the total. Companies engaged in IRC Section 41(d) research received \$101,803,777, or 7.4% of the total. Non-fossil fuel energy-related technology firms have shown the most dramatic growth in investments in recent years and received \$119.2 million or 8.7% of the total during the nine year period.

VI. COSTS IN STATE TAX CREDITS TO ATTRACT HIGH TECHNOLOGY

INVESTMENTS

a. Cumulative Costs for Investments Through 2008

For investments in QHTBs made through 2008, it is estimated that the investment credit will cost the State of Hawaii a cumulative amount of \$775.9 million in lost tax revenues (Table 2). This amount is comprised of: (a) \$438.4 million actually claimed from tax years 1999 through 2007, (b) \$135.0 million in estimated claims for tax year 2008 (this amount is estimated because the deadline to claim the 2008 credit is December 31, 2009), and (c) \$202.5 million in estimated credits to be claimed in 2009 through 2012 since taxpayers may claim these credits over a five year period, or may carry over prior year credits that they did not use because their tax liability was lower than the amount of credits in the taxable year, for investments made prior to May 1, 2009.

Table 2. Estimated Investment Tax Credit Claimed for Tax Years 1999 - 2008

Cumulative Investment Tax Credit Claimed, Tax Years 1999 - 2007 1/	\$438,358,694
Estimated Investment Tax Credit Claimed, Tax Year 2008	\$135,000,000
Estimated Investment Credit Claims, Tax Year 2009 2/	\$202,500,000
Total Investment Tax Credit Claimed, Tax Years 1999 - 2009	\$775,858,694

1/ Tax credits claimed for 2007 was revised due to adjustment made to credits claimed by individuals that were disallowed.

2/ This \$202.5 million is an estimate of carryovers and years 2 to 5 credits for investment made prior to 2009. This estimate does not include new investments that may be made in the same companies in calendar year 2009 or in future years while Act 221/215 is still in effect.

Table 3. High Technology Business Investment Tax Credits Claimed¹ for Tax Years 1999 through 2007

Year	Total No. of Claims	Total Credit	Individuals	Corporations	Financial Corporations ²	Insurance Underwriters	Fiduciaries	Exempt Organizations
1999	23	\$162,208	N/A	N/A	N/A	N/A	N/A	N/A
2000	103	393,633	N/A	N/A	N/A	N/A	N/A	N/A
2001	268	9,579,923	\$3,334,260	\$225,205	\$4,209	\$6,013,757	\$2,492	N/A
2002	493	26,185,181	11,191,036	1,710,041	-	13,057,896	226,208	N/A
2003	652	38,870,301	13,360,232	3,855,197	2,100,658	19,391,764	162,450	N/A
2004	1,040	50,543,285	26,858,573	994,571	1,599,658	20,714,206	376,277	N/A
2005	1,216	69,827,709	38,111,997	3,428,405	2,286,892	25,293,046	700,845	\$6,524
2006 ³	1,842	105,407,136	59,622,619	8,471,761	10,146,111	26,732,870	431,802	1,973
2007 ⁴	2,207	137,389,318	79,967,433	9,478,054	15,669,335	29,913,337	2,336,416	24,743
Totals	7,844	\$438,358,694	\$232,446,150	\$28,163,234	\$31,806,863	\$141,116,876	\$4,236,490	\$33,240

Source: Tax Research and Planning Office.

¹ Tax credits actually used (deducted from Hawaii income taxes due).

² Financial corporations are defined as corporations that file Form F-1, the Franchise Tax return.

³ Revised due to late filers.

⁴ Revised due to adjustment made to credits claimed by individuals that were disallowed.

b. Who Made Investments in QHTBs and Claimed the Investment Credit

In tax year 2007, the latest year for which complete data is currently available, 2,207 taxpayers claimed investment credits of \$137.4 million (Table 3). More importantly, from 1999 through 2007, \$438.4 million in tax credits have been awarded to support high technology in Hawaii. This is a significant loss of revenue to the State Treasury and demonstrates a high fiscal commitment to this industry sector as a result of laws enacted over the past ten years.

Of the \$438.4 million that has been claimed in nine years, individual tax filers claimed 53%, corporations including banks claimed 13.7%, and the remaining taxpayers including insurance underwriters and fiduciaries claimed 33.1% in credits.

For the most recent complete calendar year (2007), individual tax filers (2,040 returns) claimed an average of \$39,200 in tax credits during tax year 2007 (see Table 4). However, when this data is broken down by the income level of the taxpayer, over 96% of the total amount of credits claimed was by individuals with adjusted gross incomes of \$200,000 or more (1,321 returns) (see Table 5). The average claim of these higher income filers was \$58,158 per tax return.

Table 4. Returns Claiming the Investment Credit: 2007

Type of Returns	Number of Returns	Tax Credits Claims	Average Credits per Return
Individuals ¹	2,040	\$79,967,433	\$39,200
Corporations	60	\$9,478,054	\$157,968
Financial Corporation ²	5	\$15,669,335	\$3,133,867
Insurance	36	\$29,913,337	\$830,926
Fiduciary	63	\$2,336,416	\$37,086
Exempt	3	\$24,743	\$8,248
Totals	2,207	\$137,389,318	\$62,252

Source: Tax Research and Planning Office.

¹ Revised due to adjustment made to credits claimed by individuals that were disallowed.

² Financial corporations are defined as corporations that file Form F-1, the Franchise Tax return.

Table 5. Individuals Claiming the Investment Credit by Hawaii AGI: 2007

Adjusted Gross Income		High Tech Investment Credit	
At least	But less than	Number of Returns	Total Credit Claimed
	\$5,000	8	\$485
\$5,000	\$10,000	8	\$787
\$10,000	\$20,000	20	\$8,987
\$20,000	\$30,000	20	\$10,058
\$30,000	\$40,000	20	\$19,132
\$40,000	\$50,000	30	\$50,537
\$50,000	\$60,000	34	\$74,716
\$60,000	\$70,000	40	\$97,639
\$70,000	\$80,000	40	\$110,233
\$80,000	\$90,000	49	\$142,307
\$90,000	\$100,000	36	\$121,709
\$100,000	\$150,000	219	\$1,065,904
\$150,000	\$200,000	195	\$1,439,893
\$200,000		1,321	\$76,825,046
TOTAL		2,040	\$79,967,433

c. The Research Activities Tax Credit

Cumulative claims of the research credit totaled \$102.8 million from tax years 2000 through 2008 (Table 6). As stated in the introduction section of this report, the research tax credit is a refundable credit available to qualified high technology businesses that engage in research activities as defined by the Internal Revenue Code in Hawaii. It should be noted that the amount of research credits claimed for tax year 2008 varies between \$14.3 million and \$16.9 million, depending upon whether we aggregate the data on Form N-317 versus Form N-319A. The difference between the \$14.3 million and the \$16.9 million may exist for several reasons. First, QHTBs that claim the research credit and received investments more than five (5) years ago are not penalized for failing to

file the Form N-317. Second, QHTBs that claim the research credit and received investments prior to July 1, 2007 are also not penalized for failing to file the Form N-317. Third, the Form N-319A is based upon estimates in certain cases because of the March 30th deadline.

Table 6. Estimated Research Credit Claims for Tax Years 2000 - 2008

Cumulative Research Credit Claimed, Tax Years 2000 - 2007	\$88,488,359
Estimated Research Credit Claims, Tax Year 2008 1/	\$14,338,782
Total Research Credit Claims, Tax Years 2000 - 2008	\$102,827,141

1/ Research Credit Claims as reported by 203 QHTBs in the 2008 Form N-317s. Research Credit claims as reported by 114 QHTBs in the 2008 Form N-319As totaled \$16.9 million.

VII. JOB CREATION

a. Jobs Reported by QHTBs

Data from the 203 QHTBs that filed Form N-317 for calendar year 2008 show that these firms paid wages to 1,861 Hawaii workers in calendar year 2008, including full-time, part-time, and temporary workers. Full-time workers earned an average annual wage of \$71,679 and part-time workers earned an average annual wage of \$30,355. The number of full-time jobs remained steady at 1,450 full-time jobs. Part-time jobs decreased from 169 to 154. Temporary jobs substantially declined from 641 to 242. In aggregate, this data reflects a decline from a 2,245 workforce in 2007 to a 1,861 workforce in 2008 (Table 7).

These 203 firms reported spending \$107.9 million to hire 2,840 independent contractors in Hawaii in 2008 (Table 8). This is an increase from the prior year of 2,118 independent contractors used by high technology firms in 2007. The bulk of the contractor payroll occurred in the performing arts sector (60.2%) and it should be noted that this sector expended only \$1.6 million for non-contractor employment in 2008.

Table 7. Average Wages for QHTB Employees

Salary Range	Full Time		Part Time		Temporary	
	Jobs	Wages*	Jobs	Wages*	Jobs	Wages
Under \$30,000	111	\$1,665,000	113	\$1,695,000	242	n/a
\$30,000 to \$59,999	523	\$23,535,000	35	\$1,575,000	n/a	n/a
\$60,000 - \$99,999	517	\$41,360,000	17	\$1,360,000	n/a	n/a
\$100,000 and over	299	\$37,375,000	4	\$500,000	n/a	n/a
TOTAL	1,450	\$103,935,000	169	\$5,130,000	242	n/a
AVERAGE WAGE		\$71,679		\$30,355		n/a

Table 8. Hawaii Payroll Expenses, Research Credits, and Contractors Hired and Expenses (2008 Filers)

Activity	No. of QHTBs	Payroll	Research Credit Claimed	Independent Contractors Hired	Contractor Expenses
Research as in IRC Sec. 41(d)	15	\$9,387,389	\$2,047,283	88	\$14,889,656
Biotechnology	18	\$12,110,695	\$1,903,408	101	\$3,965,961
Computer Software	45	\$28,653,084	\$1,782,053	172	\$3,767,041
Non-fossil Fuel Energy	20	\$3,339,740	\$391,763	61	\$3,035,525
Performing Arts	50	\$1,632,258	\$0	2,121	\$64,964,588
Multiple Activities & Others	55	\$69,084,086	\$8,214,275	297	\$17,278,161
TOTAL	203	\$124,207,252	\$14,338,782	2,840	\$107,900,932

b. Estimated Impact of the High Technology Business Investment Tax Credit and the Tax Credit for Research Activities on Technology Employment in Hawaii

As noted last year, the HISciTech Institute in 2007 issued a report on the number of technology jobs in Hawaii in a report titled "Innovation and Technology in Hawaii: An Economic and Workforce Profile."³ The HISciTech Report estimated that Hawaii's technology sector employed 31,106 people earning an average annual salary of \$68,935. Of the 31,106 total

³ The study by HISciTech is available at http://www.hiscitech.org/data/n_0001/resources/live/Innovation+Tech+Hawaii+Report+Sept30.pdf.

technology positions, the HISciTech Report estimated 23,985 of these jobs were with private sector companies and 7,121 positions were in public sector agencies.

Notably, between 2002 and 2007, the HISciTech Report estimated that the number of technology jobs in Hawaii increased by 3,557 in the private sector and 601 in the public sector, or a total increase of 4,158 positions in technology fields. The HISciTech Report utilized data from Economic Modeling Specialists Inc. (EMSI) that is based upon U. S. Bureau of Economic Analysis (BEA) data. The technology jobs identified by the HISciTech Report covered private, county, State, and civilian federal government positions, jobs in the military, and self-employed individuals, as well as other positions not covered by unemployment insurance (UI), usually certain owners or part-time employees working less than 20 hours per week.

Overlaying the 1,861 jobs reported by the 203 QHTBs with the 3,557 jobs in the HISciTech Report implies that these 203 QHTBs were responsible for 52% of total private sector technology job creation in Hawaii between 2002 and 2008. What is useful to note at this juncture is the employment in high technology companies filing reports in 2008 who received Act 221 credits declined 17% when comparing 2008 employment data to 2007. The high technology sector hired more independent contractors for a net increase of 34% over the 2007 levels.

While it is encouraging to see a net increase in the total number of individuals receiving some form of employment between 2007 and 2008 (4,363 contractors, full, part, and temporary employees in 2007 compared to 4,701 in 2008), these gains were made at a cost of \$137.4 million in tax credits.

VIII. VIABILITY AND SUSTAINABILITY OF QHTBs

To measure the viability of the QHTBs, the Department reviewed the QHTBs' revenues, expenses, and the length of time a QHTB has been in business.

Qualified high technology companies, in aggregate, are experiencing negative cash flows. In 2008, the worldwide gross revenue of the QHTBs totaled \$207.7 million, which was substantially less than their worldwide total expenses (excluding capital expenditures) of \$378.2 million. It should be noted that losses are not unusual for businesses in the early stages of their development (Table 9).

Of the 203 filers of Form N-317 for calendar year 2008, 110 were engaged in their qualifying activity for more than three years and 57 were engaged in the qualifying activity for more than 5 years (Table 10).

Of the 203 filers in 2008, only 59 had revenues greater than or equal to their expenses during 2008 and only 541 of the total full time jobs reported by QHTB firms were associated with companies that made a profit last year. This is 37% of the reported full time jobs. It should be noted that firms, even those experiencing a negative cash flow, may hold assets of value, such as patents not yet commercialized or copyrights that could be sold or licensed at a future date in or outside Hawaii.

Table 9. 2008 Hawaii Revenues, Expenses, and Jobs (2008 Filers)

A. QHTBs with Worldwide Revenue Greater than or Equal to Worldwide Expenses

	Number of QHTBs	Hawaii Revenues	Hawaii Expenses	Number of Jobs
Research as in IRC Section 41(d)	3	\$9,101,371	\$4,513,034	12
Biotechnology	1	\$1,699,122	\$278,387	7
Computer Software	13	\$11,833,977	\$8,956,858	68
Non-fossil Fuel Energy	7	\$22,980,926	\$13,686,616	18
Performing Arts	15	\$5,592,294	\$2,411,170	15
Multiple Activities & Others	20	\$77,082,541	\$63,056,574	421
TOTAL	59	\$128,290,231	\$92,902,639	541

B. QHTBs with Worldwide Revenue Less than Worldwide Expenses

	Number of QHTBs	Hawaii Revenues	Hawaii Expenses	Number of Jobs
Research as in IRC Section 41(d)	12	\$1,711,116	\$25,943,905	100
Biotechnology	17	\$9,040,946	\$32,994,146	96
Computer Software	32	\$25,512,256	\$49,997,894	314
Non-fossil Fuel Energy	13	\$4,515,484	\$8,630,832	34
Performing Arts	35	\$1,532,168	\$93,669,479	16
Multiple Activities & Others	35	\$37,127,984	\$74,097,555	349
TOTAL	144	\$79,439,954	\$285,333,811	909

C. ALL QHTBs that Filed in 2008

	Number of QHTBs	Hawaii Revenues	Hawaii Expenses	Number of Jobs
Research as in IRC Section 41(d)	15	\$10,812,487	\$30,456,939	112
Biotechnology	18	\$10,740,068	\$33,272,533	103
Computer Software	45	\$37,346,233	\$58,954,752	382
Non-fossil Fuel Energy	20	\$27,496,410	\$22,317,448	52
Performing Arts	50	\$7,124,462	\$96,080,649	31
Multiple Activities & Others	55	\$114,210,525	\$137,154,129	770
TOTAL	203	\$207,730,185	\$378,236,450	1,450

Table 10. Number of QHTBs Performing Qualifying Activities and Duration of Activity (2008 Filers)

Number of Years the QHTB Performed the Qualifying Activity

Activity	0-1 Years	2-3 Years	4-5 Years	6 or more Years	Total
Research as in IRC Sec. 41(d)	0	4	5	6	15
Biotechnology	3	5	3	7	18
Computer Software	5	11	17	12	45
Non-fossil Fuel Energy	4	9	4	3	20
Performing Arts	17	9	15	9	50
Multiple Activities & Others	11	15	9	20	55
TOTAL	40	53	53	57	203

IX. CONCLUSION

To the extent Act 178, as amended by Act 221, is intended as a capital raising tool for Hawaii QHTBs, those filing in 2008 reported raising \$265.7 million in 2008 and a total of \$1.369 billion in cash investments from 2000 to 2008 in more than 400 companies.

Losses in tax revenues to the State of Hawaii for all QHTB investments to date total \$775.9 million in *investment* tax credits claimed and likely to be claimed in future years and \$102.8 million in *research* tax credits. Although there was a global and national recession in 2008, investments in high technology companies continued at a rate surpassing a quarter billion dollars (\$265.7 million). The State continued to experience a significant tax revenue loss of \$135 million.

To the extent Act 178, as amended, is intended to support the creation of higher-paying technology jobs reported, full time employment remained relatively steady at 1,450 jobs compared to the previous year. Part-time and, particularly temporary jobs, however, were reduced. Companies, particularly performing arts companies, shifted to a greater use of independent contractors from 1,240 to 2,121. Even looking at the combined numbers of contractor and direct jobs, the employment impacts of Act 221 remain disappointing. However, it should be noted that actual job data has only been collected for investments on or after July 1, 2007. Also, there is lag between significant investments and possible job creation as a result of that investment.⁴

To the extent Act 178, as amended by Act 221, is intended to create viable high technology companies contributing long-term to the diversity of Hawaii's economy, 57 of the 203 QHTBs have been in business for more than five years and 59 had revenues greater than expenses. This represents a 55% increase in the number of firms showing a positive cash flow compared to a year ago. Future year data will be needed to determine if at least some portion of high technology

⁴ Because a substantial portion of each year's investments are generally made toward the end of a year, there is a lag or delay between estimated credit costs in that year and any jobs created in the following year. For example, investments made at the end of a year may finance jobs in the subsequent year.

businesses in Hawaii remain as sustainable, on-going operations and contribute to the future recovery of our economy.