

HOUSE RESEARCH

Bill Summary

FILE NUMBER: H.F. 503 **DATE:** March 19, 2001
Version: As amended with author's amendment
Authors: Pawlenty and others
Subject: Research and Investment Credits
Analyst: Joel Michael (651-296-5057)

This publication can be made available in alternative formats upon request. Please call 651-296-6753 (voice); or the Minnesota State Relay Service at 1-800-627-3529 (TTY) for assistance. Summaries are also available on our website at: www.house.mn/hrd.

Overview

This bill provides three incentives for business investment:

The **research credit** is extended to the individual income tax and the credit rate is increased to a flat 5% rate for all businesses, making its incentive effect equal regardless of the amount of increasing research expenditures. Under present law, the credit applies only to the corporate franchise tax and the 5% credit rate drops to 2.5% for expenditures over \$2 million.

An **investment tax credit** is provided against the individual income tax for passive investments in small businesses (newly formed or gross revenues of less than \$5 million). The credit equals 25% of the investment in equity securities or subordinated debt up to a maximum credit of \$50,000.

A **sales tax exemption for research expenditures** is provided. This exemption applies to business purchases of supplies and equipment used to conduct research that qualifies for expensing of research expenditures under the federal income tax rules. Although the federal expensing rules are limited to ordinary expenses (e.g., supplies and personnel costs), the sales tax exemption under the bill also applies to purchases of depreciable property (e.g., equipment with useful lives longer than a year).

1 Research credit, application to individuals. Extends the credit for increasing research expenses ("research credit") to individuals. Under present law, the research credit applies only to the corporate franchise tax. From its enactment in 1981 through 1987, the research credit was allowed to individual taxpayers. In 1987, tax reform limited its application to C corporations.

Flat credit rate. This section increases the credit rate from 2.5% to 5% for expenditures in excess of \$2 million. Under present law, a tiered credit rate applies: 5% for the first \$2 million or expenses and 2.5% for the amount over \$2 million.

2 Application to individuals. Makes conforming changes in carryover provisions reflecting section 1's

allowance of the credit to individuals.

3 Application to individuals. Provides that allocation of the credit for individuals will be done in the same way as federal law. This restricts the credit to the tax that is attributable to the trade or business activity that generated the credit. Thus, the credit cannot be used to shelter tax derived from other income (e.g., wages or salaries or other investment income).

4 Investment credit, definitions. Defines terms for purposes of the investment credit under sections 4 to 7.

Business includes essentially any type of for profit business entity (corporation, partnership, limited liability company, and so forth).

Equity security includes:

Common stock

Preferred stock

Partnership interests

Subordinated debt that is convertible into common stock

Pass-through entity means an entity that is taxed as either an S corporation or partnership.

Qualified business venture is a business that means the requirements under section 6.

Security is a security as defined under section 2(1) of the 1933 federal Security Act. This is a very expansive definition of securities and is not limited to securities that are required to be registered under the 1933 Act.

Subordinated debt means unsecured debt that is subordinated to all other debt of the business issued to financial institutions.

5 Investment tax credit. Allows an credit against the individual income tax for investments in a qualified business venture equal to 25% of the amount of the investment, subject to a maximum of \$50,000 for all investments made during the taxable year. The credit is allowed in the year after the investment is made. The credit applies to both regular and alternative minimum tax. The investment may be made in either equity or subordinated debt.

Rules for pass-through entities. Pass-through entities (partnerships and S corporations) are allowed the credit, if they do not have more than \$5 million in committed capital under management. The pass-through entity will pass the credits through to their owners (shareholders or partners) in the same manner as other tax attributes. If the \$50,000 maximum limit applies to any partner or shareholder, the pass-through entity may not reallocate the unused credit (i.e., amount over the maximum) to other owners of the pass-through entity.

Maximum limit per entity. Under the author's amendment, both pass-through entities and C corporations are subject to a maximum annual credit limit of \$750,000. This would represent a minimum investment of \$3 million. If the entity has more purchasers of its equity or subordinated equity than the \$3 million limit, each investor will receive a proportionately reduced credit so that the total amount of credits for the business do exceed the \$750,000 limit.

Application. To receive a credit, the taxpayer applies to DOR by April 15 of the year after the investment is made. (The commissioner may extend this deadline up to September 15.) DOR specifies the form of the application and supporting documents that are required. If investments were made in other than cash, certified appraisals of this property must be included with the application.

Carryover. The credit is not refundable, but may be carried over to the succeeding five taxable years. Amounts carried over do not count against the \$50,000 maximum in the year to which they are carried.

Aggregate limit. The total amount of credits are limited to an unspecified dollar amount in each calendar year. If applications are received that would result in a total amount of credits being allowed over the annual limit, the commissioner is to reduce the credits allowed proportionately to keep the

total amount within the cap. DOR will notify taxpayers who applied for credits by December 31. No adjustment is made if more credits are applied for than are claimed.

6 Registration of qualified business ventures. Establishes the qualifying rules and procedures for obtaining and renewing registration as a qualified business venture. This status is required to allow investors to claim the investment tax credit. Applications must be made to the commissioner of trade and economic development (DTED).

Qualifying rules. To be a qualified business venture, each of the following rules must be satisfied when the application is made (essentially it must have no more than \$5 million in revenue and must not be engaged in a prohibited line of business).

Gross revenue limitation. It must be newly organized (within the calendar year in which the application is filed) or if it is not newly organized, it must for its most recent fiscal year have gross revenues of \$5 million or less

Permitted lines of business. Its line of business must be manufacturing, processing, warehousing, wholesaling, research and development, or a service related business.

Prohibited lines of business. It may not have a *substantial part* of its business in any one of the following business:

Professional services (e.g., physicians, dentists, lawyers, engineers, architects, accountants, and other licensed professions)

Construction or contracting

Investment, lending, and similar financial intermediary functions

Personal grooming or cosmetics services

Entertainment, amusement, recreation, or athletic or fitness activity for which admission or membership is charged

Real estate related business (brokerage, buying, selling, leasing or managing real estate)

Retail sales (selling any product or service through stores or locations open to the public generally)

Effective date of registration. Registrations take effect 60 days *before* application for registration is filed with DTED. Credits are not allowed if the investment is made before the effective date of the registration. Investments can qualify by being put into escrow before this date, but release of the funds is conditioned upon obtaining other investors' commitments. In this instance, the investment date is when the escrow is released.

Renewal required. The qualified business venture must annually file for renewal of its registration. The renewal filing consist of a financial statement showing it continues to meet the \$5 million annual revenue limitation and certification that it meets the other requirements. If the business doesn't file for renewal, its revocation is revoked. This eliminates the ability of investors to claim credits for new investments and raises the price of obtaining qualified business venture status again at a later point, but has no other consequence. Previously granted credits are not forfeited. DTED is to mail notification of revocation to the business. Application for reinstatement carries a \$1,000 fee (as compared with the fee for a new filing of \$100).

Businesses are required to notify DTED if their gross revenues exceed \$5 million in a year.

Forms and fees. DTED prescribes the application forms and may require additional supporting information be filed. The filing fee for an initial application is \$100 and \$50 for renewals. Renewal applications must report the number of jobs created in the previous year that are attributable to the investments.

Revocation. DTED is to revoke a registration if it discovers the application contained false information. (One presumes that the false information would be required to be material to the

application--i.e., that it would have resulted in disqualifying the business from obtaining registration as a qualified business venture.) Ceasing to operate, however, does not in itself result in revocation of registration.

Transfers of registration. Businesses are not allowed to transfer or sell registrations. However, merger, consolidations or similar transaction can result in transfer of the status, if the surviving business meets the criteria for a qualified business venture. Written notice of the transaction must be given to DTED.

Report by DTED. DTED is required to report annually to the legislature on the registrations: names and addresses of businesses, description of the types of businesses, the number of jobs created, and the average wages paid.

7 **Forfeiture of credit.** Provides a taxpayer forfeits the credit under this section in three circumstances:

(1) Participation by the investor in the business. If the taxpayer participates in the operation of the business within 3 years after making the investment, the taxpayer's credit is forfeited. Participation can be done by (1) the taxpayer, (2) a family member of the taxpayer, (3) an employee of the taxpayer or a family member, or (4) a business controlled by one of those individuals. Family members include a spouse, parent, child, or sibling. Active participation is defined as providing services for compensation, other than reimbursement for expenses. Control of a business is defined as owning more than 10% of the voting securities of the entity.

(2) False application. If false information was submitted in the application for registration and the registration is revoked, the tax credits are forfeited.

(3) Transfer or redemption of investment. The investment credit is forfeited if:

Transfer. The taxpayer transfers the securities within 1 year after making the investment. This doesn't apply if the transfer was a result of (1) the death of the taxpayer, (2) a final distribution in liquidation of the taxpayer, or (3) a merger, consolidation or similar transaction.

Redemption. The qualified business venture redeems the taxpayer's interest within 5 years after the investment was made. If this a partial redemption of the taxpayer's interest, the amount of the credit that is forfeited is in proportion to the amount of the taxpayer's securities that qualified for the credit that are redeemed. If it is a full redemption of the taxpayer's interest, but the amount received is less than that invested by taxpayer, the amount of the credit is also apportioned.

Effect of forfeiture. Forfeiture of the credit requires payment of the taxes with interest back to the time when the taxes would have been payable absent the credit. Payment is due 30 days after the credit is forfeited. Failure to pay is subject to the civil penalties for failure to pay.

8 **Sales tax exemption, research supplies and equipment.** Exempts from the sales tax purchases of supplies, equipment, and taxable services made for qualifying research by a business. Qualifying research is defined by reference to the federal law allowing expensing of research expenditures. However, the disallowance under federal law for depreciable property does not apply. Thus, any expenditures (whether for supplies or depreciable equipment) would qualify for the exemption, if they are for "research and experimental" purposes. Federal law provides this means "research and development costs in the experimental or laboratory sense. The term generally includes all such costs incident to the development or improvement of a product." Treas. Reg. § 1.174-2(a). They do not include ordinary testing or inspection of materials for product quality control, surveys, management studies, and so forth.

9 **Appropriation.** Appropriates an unspecified amount to DTED for the cost of administering the registration of qualified business ventures. The amount of this appropriation is limited to the amount of fees collected from applicant businesses.