Small Business Startup Tax Credit

Recommendation

Establish a new tax exclusion for capital gains on stock acquired by founders and investors in qualifying South Carolina startup companies. Basing eligibility for such a credit to "qualified businesses" under the state's existing High Growth Small Business Job Creation Act, also known as the Angel Investor Act, would effectively target the proposed incentive to investors in startup companies with disproportionate potential for rapid growth and high job creation.

Eligibility

Founders and investors in "qualified businesses" under the state's existing High Growth Small Business Job Creation Act, also known as the Angel Investor Act. Under the Act, "qualified businesses" must meet the following requirements:

- Be a corporation, limited liability company, general partnership or limited partnership located and headquartered in the State of South Carolina
- Have been organized for no more than five years before the qualified investment was made
- Have 25 or fewer employees
- Have had a gross income of $2 million or less in any complete fiscal year before registering as a qualified business
- Be primarily engaged in one of the following activities:
    - Manufacturing
    - Processing
    - Warehousing
    - Wholesaling
    - Software development
    - Information technology services
    - Research and development
    - Ambulatory health care services
    - Hospitals
    - Nursing and residential care facilities
- Not be substantially engaged in any of the following activities:
    - Retail sales
    - Real estate or construction
    - Professional services
    - Gambling
    - Natural resource extraction
    - Financial brokerage, investment activities, or insurance
    - Entertainment, amusement, recreation, or athletic or fitness activity for which an admission or fee is charged

Benefits

- Improves availability of startup capital by encouraging individuals to invest in South Carolina startup companies
- Provides tax credits only for successful ventures
- Spurs economic growth and job creation before credits are taken
- Places more capital in the hands of experienced investors who have previously invested in successful startup companies
- Encourages the creation of companies that will attract follow-on investments, and subsequent taxable gains, from venture funds and public equity markets

Cost/Fiscal Impact

Annual cap of $10 million. Seed and other early stage investments in startup companies are in the range of $50,000 to $1 million. Typically, these initial investments are followed by subsequent equity rounds funded by venture capitalists and public equity markets. Since its inception in 2006, the South Carolina Research Authority's SC Launch Program has invested approximately $29 million in seed investments. This has led to over $1 billion in follow-on investments. The proposed legislation would make the majority of such follow-on investments ineligible for the proposed credit. Therefore, although the fiscal impact of the proposed exclusion will be driven largely by small, early-stage investments, the overall economic impact of the proposal will be driven by follow-on investments likely to be exponentially larger. Taxation of these cash flows may well result in additional state revenues that substantially offset, or even exceed, the fiscal impact of the proposed credits. Moreover, because follow-on equity investments will typically precede initial investors' cash outs, the state is likely to derive material revenue gains from the proposed exclusion even before negative fiscal impacts of the exclusion are realized.

Track Record of Similar Programs in Other States

A similar concept was proposed in North Carolina; however, the legislation was not enacted. Therefore, there is no track record upon which to draw.