

# **State of Rhode Island - Division of Taxation**

## **Tax Credits/Deductions**

### **Regulation CR 88-02**

#### **Small Business Capital Development**

#### **I. GENERAL**

Chapter 43 of Title 44 of the Rhode Island General Laws provides special tax incentives for small business capital development. These special incentives are of three types: deductions or modifications for investment, capital gain exclusions and wage credits.

#### **II. CERTIFICATION**

No deductions, modifications, capital gain exclusions or wage credits will be allowed unless the qualifying business entity or certified venture capital partnership has been certified (or recertified) by the Department of Economic Development to tax incentive eligibility. The certification number must be shown where required on all tax incentive claims.

#### **III. DEFINITION**

In general, definitions and regulations set out by the Department of Economic Development in accordance with 44-43-7 will be used in administering the small business capital development incentives unless a different meaning is clearly intended.

A. "Entrepreneur" means any individual employed full time by the qualifying business entity who owns an equity interest in the qualifying business entity of at least 5% of the value of the entity.

B. "Value of the entity" means the net book value of the entity as shown on the entity's books and records computed for each calendar year for the purposes of calculation of the wage credit.

C. "Wages" means the sums defined in Section 3121(a) IRC 1954.

D. "Qualifying investment" means that part of a taxpayer's investment in a certified venture capital partnership (Section 702(a)(8) IRC 1954) that was invested by the partnership in qualifying business activities during the taxpayer's taxable year.

#### **IV. DEDUCTIONS OR MODIFICATIONS**

A. General: As applicable, deductions or modifications for investments in certified venture capital partnerships or in qualifying business entities are allowed in the computation of business corporation tax (44-11), public service corporation tax (44-13), bank excise tax (44-14), gross premiums tax (44-17) and personal income tax (44-30).

B. Calculation and Documentation: The deduction or modification allowed is equal to the

taxpayer's qualifying investment in a certified venture capital partnership or equal to the entrepreneur's investment in a qualifying business entity. The amount is measured at the year end of the certified venture capital partnership, the year end of the qualifying business entity or the year end of the investing taxpayer, whichever comes first. The deduction or modification is allowed only in the year in which the taxpayer first makes an investment.

EXAMPLE: C Corporation makes a first time investment of \$40,000 in a certified venture capital partnership which invests 90% of its capital in qualifying activities. All year ends coincide. C Corporation may deduct 90% of the \$40,000 or \$36,000 from net income in computing its business corporation tax under 44-11.

EXAMPLE: John Taxpayer is an entrepreneur in Small Company, a qualifying business entity, and makes two investments of \$10,000 each. One investment is made on March 10 and the other is made on July 10. John is a calendar year taxpayer and Small Company is a June 30 year end. John is entitled to a modification of \$10,000 reducing his federal adjusted gross income because Small Company's year end (June 30) occurs first and, at that time, John had made only the March 10th investment of \$10,000.

Taxpayers seeking the deduction or modification must provide proof of the investment in a certified venture capital partnership or qualifying business entity; of that partnership's or entity's status AT THE DATE OF INVESTMENT; of the amount of investment and of the year ends of the taxpayer and partnership or entity. The taxpayer must show the certification number of the certified venture capital partnership or qualifying business entity where indicated on appropriate tax forms.

#### C. Restrictions and Carryovers:

1. The deduction or modification cannot reduce the business corporation tax, public service corporation tax or bank excise tax to less than \$100.
2. The deduction or modification cannot reduce the personal income tax or gross premiums tax to less than \$0.
3. If the investor entitled to a deduction is a partnership, joint venture or small business corporation, the deduction shall be divided in the same manner as income.
4. The deduction allowed in the computation of net income (business corporation tax) shall only be allowed to that corporation (included in a consolidated return) that qualifies for the deduction and may not be used in the computation of net income of other corporations that may join in the filing of a consolidated return.
5. Amounts of unused deduction or modification may not be carried over to the following year.

#### D. Recapture:

1. The taxpayer or entrepreneur which has been allowed a deduction or modification must recapture ALL the deduction or modification in the year:

(a) the taxpayer or entrepreneur sells, exchanges or otherwise has a reduction in his/her interest in a qualifying business entity, or

(b) in which there is a reduction in the taxpayer's interest in a qualifying investment in a certified venture capital partnership.

2. The recapture is limited to the proceeds resulting from any such reduction.

3. There will be no recapture as a result of the death of an entrepreneur or taxpayer, nor will there be recapture of any investment held by the entrepreneur or taxpayer for at least 5 years.

## V. CAPITAL GAINS EXCLUSION

A. General: The calculation of business corporation tax, public service corporation tax, bank excise tax or personal income tax may exclude long term capital gains from the sale or exchange of an interest in a qualifying business entity or certified venture capital partnership.

B. Calculation and Documentation: To the extent that a long term capital gain (Section 1222(3) IRC 1954) was included in the calculation of tax under 44-11, 44-13, 44-14 or 44-30, the gain shall be excluded if:

(1) it is recognized by a partner in a certified venture capital partnership from the sale or exchange of an interest in the partnership, or

(2) it is a partner's distributive share (from a certified venture capital partnership) of a long term capital gain recognized by the partnership from the sale or exchange of an interest in a qualifying business entity; or

(3) it is recognized by an entrepreneur from the sale or exchange of an interest in a qualifying business entity.

EXAMPLE: B Corporation is a one-half partner in a certified venture capital partnership. During the year, the partnership sold an interest in a qualifying business entity resulting in a long term capital gain of \$250,000. The partnership invests 100% in qualifying activities. B Corporation is entitled to exclude its distributive share or \$125,000 from its calculation of business corporation tax under 44-11.

Because of the length of time which may pass between the certification of businesses as either qualifying business entities or as certified venture capital partnerships, the investment in these businesses and the subsequent sale or exchange resulting in long term capital gains, taxpayers seeking exclusion of the gain must provide proof of the date and amount of the investment in the qualifying business entity and/or certified venture capital partnership. Taxpayers must also provide documentation that the entity or the partnership had been properly certified by the Department of Economic Development when the taxpayer acquired the interest. Additionally, in the case of the distributive share from a certified venture capital partnership, it is the taxpayer's responsibility to secure and retain documentation that the business entity in which the partnership invested was properly certified by the Department of Economic Development at the time the partnership invested.

## VI. WAGE CREDIT

A. General: A credit is available against an entrepreneur's personal income tax (44-30) for his/her share of wages paid by a qualifying business entity.

**B. Calculation and Documentation:** The wage credit is computed annually beginning with the first calendar year in which the business first qualified as a qualified business entity. The credit is first computed at 3% of the wages paid to employees for the calendar year in excess of \$50,000 and excludes (1) wages paid to owners; (2) wages paid more than 5 years after the start or purchase of the business; and (3) wages paid to employees who are not principally employed in Rhode Island and whose wages are not subject to Rhode Island withholding. The credit is then divided among the entrepreneurs of the qualifying business entity by using the ratio of each entrepreneur's interest compared to the total interest held by all entrepreneurs.

**EXAMPLE:** A corporation has been certified as a qualifying business entity and, for its first year of certification, it paid \$300,000 in wages to employees. It has been in business for 2 years. Part of the wages paid include \$20,000 to owners and \$22,000 paid to sales people working in Massachusetts and subject to Massachusetts withholding. The total credit is computed as follows:

Total Wages \$300,000

Base Exclusion 50,000

Subtotal \$250,000

Owners' Wages 20,000

Out-of-State Wages 22,000

Eligible Wages \$208,000

@ 3%

Credit \$ 6,240

The credit is then divided among the entrepreneurs according to their interests in A Corporation. If there were two entrepreneurs in A Corporation with equal interests, each would be eligible for a \$3,120 credit against his/her Rhode Island personal income tax.

Documentation showing the composition and calculation of the total credit by the qualifying business entity and of each of the entrepreneur's shares shall be prepared by the qualifying business entity and shall be attached to the personal income tax return of each entrepreneur claiming a share.

#### **C. Restrictions and Carryovers**

(1) The wage credit cannot reduce the entrepreneur's personal income tax to less than \$0 and is not refundable.

(2) Amounts of wage credit available to the entrepreneur may not be applied against his/her tax liability until all other credits available to the entrepreneur have been applied.

(3) Amounts of unused wage credit may not be carried over to the following year.

(4) The wage credit ceases in the tax year following the year in which the qualifying business entity's average annual gross revenue exceeds \$1,500,000.

R. GARY CLARK TAX ADMINISTRATOR

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