

# THE NORTH CAROLINA QUALIFIED BUSINESS TAX CREDIT PROGRAM

Investors and businesses that are seeking to raise capital should be aware of North Carolina's Qualified Business Tax Credit Program, which provides significant tax benefits to North Carolina taxpayers in connection with their investments in certain types of businesses. The program is administered by the Secretary of State and provides taxpayers a credit (i.e., a dollar-for-dollar reduction in the amount of taxes owed) against North Carolina state income tax liability when they invest in a Qualified Business Venture, Qualified Grantee Business, or a Qualified Licensee Business.

## Qualification of the Business

In order for an investment to be eligible for the credit, the company in which the investment is made must complete an Application for Registration as a Qualified Business. The fee for the application is \$100. Generally, the company is required to submit a certified financial statement (i.e., reviewed or audited by an independent certified public accountant) with its application. However, a new company formed in the calendar year of its application is not required to submit a financial statement until the following year when the registration is renewed. In addition, a company formed prior to the calendar year of its application may obtain a conditional registration if furnishing the financial statement with the initial application would impose an undue hardship on the company. The conditional registration will be canceled if the certified financial statement is not filed within five months after the end of the company's fiscal year.

As noted above, there are three types of Qualified Businesses:

- In order to be a **Qualified Business Venture**, a company must i) engage primarily in manufacturing, processing, warehousing, wholesaling, research and development, or a service-related industry, ii) be organized in the calendar year in which the application is filed, or if organized earlier, have gross revenues of \$5,000,000 or less during its most recent fiscal year, and iii) not engage as a substantial part of its business in providing professional services (such as medical or legal services), construction or contracting, selling or leasing at retail, investing, entertainment or recreation, or managing or operating real estate.

*By Stephanie Sanders*



- In order to be a **Qualified Grantee Business**, during the current year or any of the preceding three years, a company must have received funding from a federal agency under the Small Business Innovation Research Program or from a "granting entity." A "granting entity" must have as its principal purpose stimulation of development of the biotechnology industry or conducting research and development in electronic, photonic, information, or other technologies, or the stimulation of economic development based on the advancement of science, engineering, and technology, and must meet certain other statutory requirements.
- In order to be a **Qualified Licensee Business**, a company must i) currently be performing under a licensing agreement with The University of North Carolina or another research university for the purpose of commercializing technology developed at the institution, and ii) have \$1,000,000 or less in gross revenues for the most recent fiscal year.

There is no requirement that a Qualified Business be organized in North Carolina or have operations in North Carolina. The only required tie to North Carolina is that the investor must have North Carolina income tax liability in order to take advantage of the credit. Some may find this surprising, since the program is presumably intended to encourage investment and job growth within the state of North Carolina. However, this makes the credit all the more attractive to North Carolina investors, who may appreciate the ability to invest, in a tax-advantaged manner, in companies organized and operated in other states.

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## Amount of the Credit

An individual investor is entitled to a tax credit equal to 25% of the purchase price paid by the investor for the equity securities or subordinated debt of the Qualified Business purchased by the investor in the calendar year, up to a maximum credit of \$50,000. "Equity securities" include common stock, preferred stock, partnership interests, limited liability company interests, and subordinated debt that is convertible into any of the foregoing. "Subordinated debt" means unsecured debt that is subordinated to the company's bank debt and which matures at least five years after its issuance. If the investor uses non-cash consideration to pay any portion of the purchase price for the equity securities or subordinated debt of the Qualified Business, the investor must submit a certified appraisal of the value of the property used to pay for the investment. The credit is first applied against the investor's North Carolina tax liability for the year following the year of investment, and any unused credits can be carried forward for five additional years.

Subject to certain limitations, investors may also receive the tax credit if they make their investments in the Qualified Business via a pass-through entity (e.g., the equity securities or subordinated debt of the Qualified Business are purchased by an S corporation, a limited partnership, or a limited liability company in which the investor is an owner). A pass-through entity may receive a tax credit equal to 25% of the purchase price paid by it in the applicable calendar year for the equity securities or subordinated debt of a Qualified Business, with a maximum credit of \$750,000 per year. The tax credits are allocated to the pass-through entity's owners, but no owner may receive a tax credit of more than \$50,000 in one year, whether by investing directly or through a pass-through entity. The pass-through entity may not reallocate any unused credit among its other owners if this maximum is met.

In order to receive the tax credit, an investor must file an Application for Tax Credit for Qualified Business Investments (Form D-499) with the North Carolina Department of Revenue on or before April 15 of the year following the calendar year that the investment was made. This deadline may be extended, but not past October 15, and an extension to file a North Carolina tax return is not deemed to be an extension to file a Form D-499. The Department of Revenue sends notification of credit approval prior to the end of the calendar year, and the approval must be filed with the taxpayer's North Carolina income tax return.

## Limitations on the Credit

The program contains several limitations that may prevent an investor from receiving the tax credit. It is important to be aware of these limitations when structuring investment transactions, so that the tax benefit is not inadvertently lost. A few of the restrictions are as follows:

- ❑ **Not Available to Compensated Participants.** The tax credit is generally not available to anyone who participates in the operation of the Qualified Business for compensation, whether as an employee, contractor, or otherwise. An investor is, however, allowed to participate as an officer, director, or otherwise, as long as he or she does not receive any compensation other than expense reimbursements and/or participation in a stock option and/or stock bonus plan.
- ❑ **No Broker Fees.** The tax credit is also not allowed if a broker receives a fee or other similar remuneration for soliciting the investment. Only the brokered investment is disqualified, and other non-brokered investments in the same company may still be eligible for the credit.
- ❑ **Restrictions on Transfer.** Subject to certain exceptions (e.g., death, liquidation), the investor forfeits the tax credit and is liable for all tax that would have been due, plus interest, if the investor transfers any of the Qualified Business' securities within one year after the investment was made or if the Qualified Business redeems the securities within five years after the investment was made.
- ❑ **Total Dollar Limit.** The total amount of tax credits allowed to all North Carolina taxpayers in any year is \$7,500,000. If the claims made in a year exceed that amount, the Secretary of Revenue will allocate the available credits in proportion to the amounts of the credits claimed.

### Renewal

To remain qualified, a Qualified Business must renew its registration each year. The renewal fee is \$50, and a renewal application must be filed by the 15th day of the third month following the close of the company's fiscal year. Note that the renewal deadline may occur earlier than the first anniversary of the company's initial registration, depending on when the initial registration occurred. If the renewal application is not filed on time, the company's registration will be revoked, and the Secretary of State will send a notice of revocation to the company. The registration can be reinstated if the company files an application for reinstatement within 30 days after receipt of the revocation notice. The company must, however, pay a late filing penalty of \$1,000 in addition to the \$50 renewal fee. A business that seeks approval of a new application after its registration has been revoked must also pay a penalty of \$1,000 in addition to its application fee. Investments made while the registration is not in effect are not eligible for the tax credit (unless the registration is reinstated, in which case it is treated as if it was never revoked). So a company that anticipates future investments may choose to renew its registration annually, even in years that no investments are sought, in order to avoid paying the penalty to re-register if investments are made in a future year.

### Other Interesting Facts

The Secretary of State tracks the effects of the program by requiring companies that renew their registration to submit certain information, including the number of jobs created that are attributable to investments under the program. As of September 28, 2012, 109 companies are registered and 297 jobs were created in 2012 with average wages of \$40,866.67 per job.

This article is only an overview and does not cover all the intricacies of the program. Readers should consult an attorney or accountant regarding the applicability of the program to each particular situation. Attorneys at Poyner Spruill LLP have experience with the program and are available to help clients reap its benefits.

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*If you have questions or concerns regarding the NC Qualified Business Tax Credit Program or other corporate and tax transactions in general, please contact your regular Poyner Spruill attorney or any of our other corporate lawyers listed below.*



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