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

2010 Kentucky General Assembly

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1/21/2010
Version 3.1

EXECUTIVE SUMMARY

Increasing Kentucky's Competitiveness:
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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.

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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]

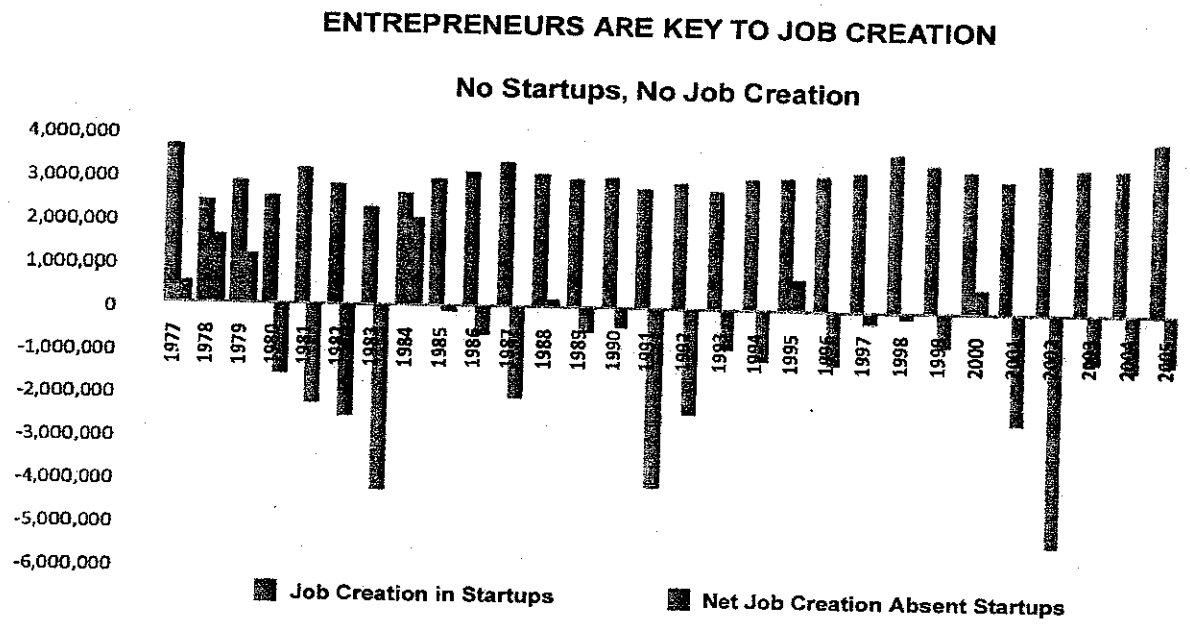

CHART 1
Source: ***Business Dynamics Statistics Briefing: Jobs Created from Business Startups in the United States.***
Kauffman Foundation, January 2009.

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."

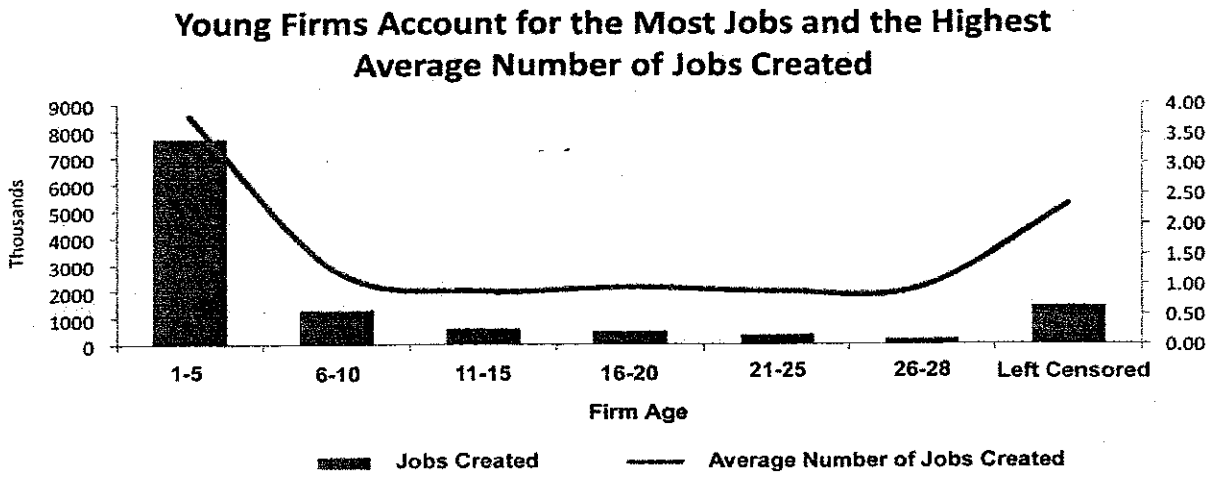

CHART 2
Source: ***Where will the Jobs Come From?*** **Kauffman Foundation, November 2009**

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]

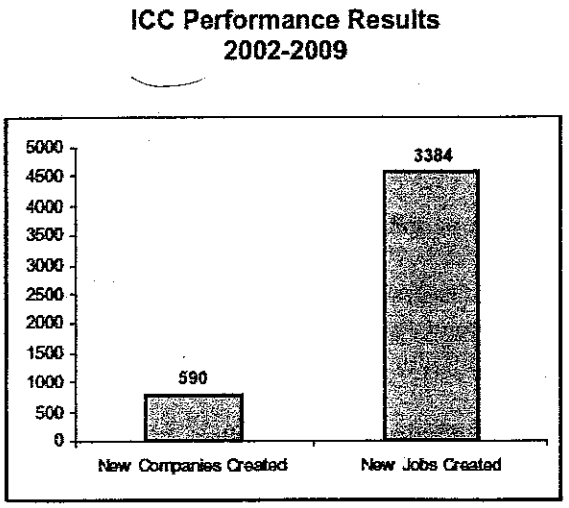

CHART 3
Source: Kentucky Science & Technology Corporation. ***Annual Report to Department of Commercialization and Innovation, Kentucky Economic Development Cabinet,*** **August 1, 2009**

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]

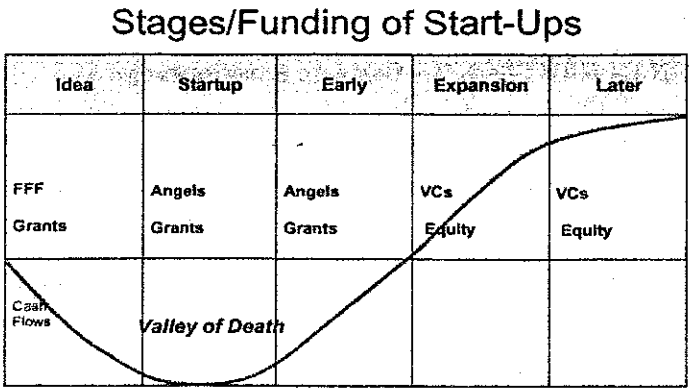

CHART 4
Source: ezone Client Education Document, 2009

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 KIFA[15] 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 program[16], angel investment industry results data[17] 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 amd 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 program[18] and general angel investment results data[19] 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 (homeruns)		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	$ 276,129,349	$ 368,427,181
Estimated State Tax Rev.	$ 551,693	$ 1,494,482	$ 3,094,377	$ 3,986,110	$ 5,187,766	$ 6,809,013	$ 8,998,384	$ 11,957,055	$ 15,957,502	$ 21,368,777

10YR TOTAL REVENUE: $ 79,405,159

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
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New Net Jobs Year 10										147
Total Jobs	147	239	390	390	451	531	637	776	959	1,199
									TOTAL	5,720

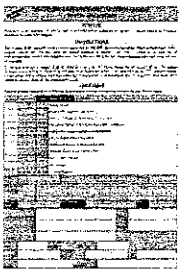
Source: Northern Kentucky Tri-County Economic Development Corporation, Barach, Casey; January 2010

ATTACHMENT

Source: Ohio Department of Development; January 2010

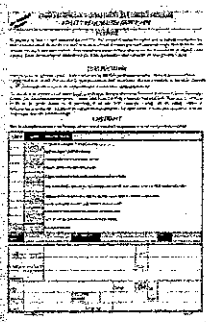
Ohio Technology Investment Tax Credit (OTITC) Processs

STEP 1: Entity Application
New companies must complete an Entity Application and submit to Edison Center before the monthly deadline. Approvals are for 1 year. Fee $150

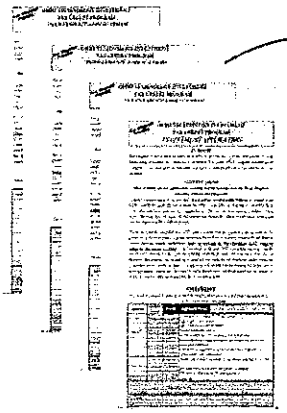


Or

Previously approved entities can requalify up to 60 days after expiration by submitting application to ODOD before the monthly deadline. Approvals are for 6 months. No Fee



STEP 2: Investment Application(s)
Each investor must submit an Investment Application for each investment into each approved entity. Fee $200 for each investment application or $800 for up to 20 applications if filed simultaneously.



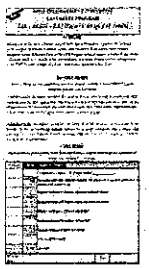
The OTITC Committee reviews and approves/disapproves all Entity, Requalification and Investment Applications on the first Thursday of each month. A new entity and investments for that entity can be approved at the same meeting. Letters are mailed after the meeting to verify approvals.

STEP 3: Make and Document Investment

Once the Committee approves both the Entity and Investment Applications, the Entity can then accept the investment

STEP 4: Submit Tax Credit Certificate Request Form

Each approved investment must be made, and the Tax Credit Certificate Request Form must be received within 120 days from the date that the committee approves the investment. Failure to submit this form in the given timeframe will cancel the credit without notice.



STEP 5: Receive Tax Credit

Within 60 days of receiving a completed Tax Credit Certificate Request Form, ODOD will mail out the tax credit to the investor

This illustration is meant to be a conceptual representation of the Ohio Technology Investment Tax Credit program and does not represent all of the requirements of the program.

For more information please contact:
Ohio Department of Development (ODOD),
Technology Division
77 South High Street, 25th Floor P.O Box 1001
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Revised 7-25-07

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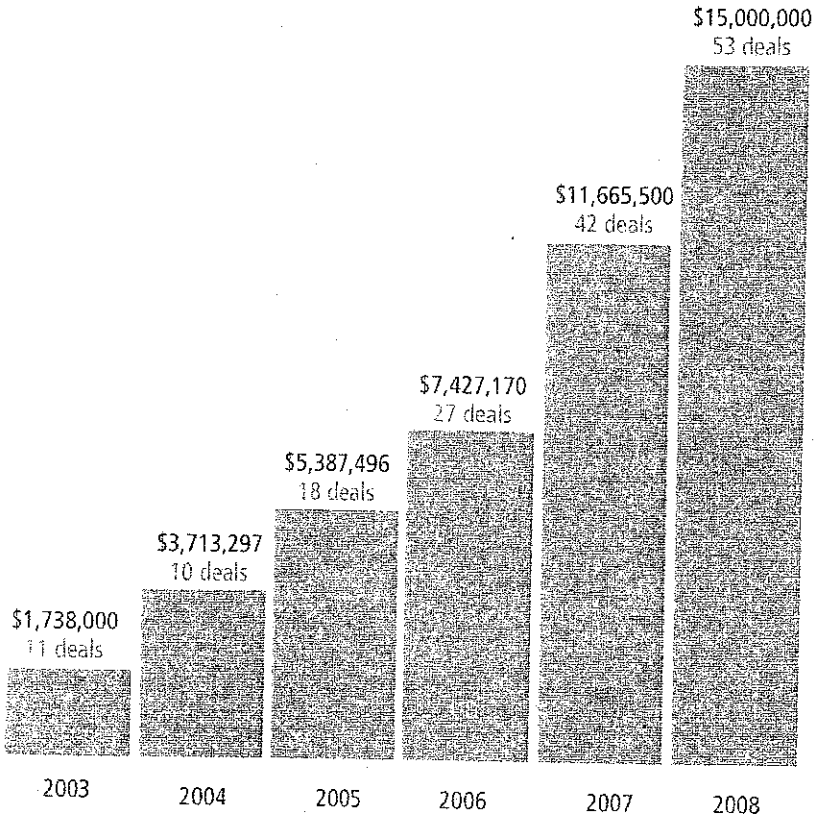
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