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ResearchReport

Bioscience Venture Capital Income Tax Deduction

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Issue

Explain the bioscience venture capital income tax deduction.

Summary

Connecticut law allows an income tax deduction for general partners of qualified venture capital funds that invest in Connecticut bioscience businesses (CGS 12-704g). Qualified venture capital funds are those that (1) meet the federal definition of a venture capital fund and (2) were established on or after January 1, 2018.

General partners are the managing partners of venture capital funds. They receive compensation primarily in two forms: (1) annual management fees and (2) a portion of the fund's profits, which is known as the "carry" or "carried interest." For Connecticut income tax purposes, general partners may deduct their portion of this income that is attributable to investments in Connecticut bioscience businesses, calculated as described below.

To claim the deduction, general partners must complete Schedule CT-BIO when they file their taxes.

Deduction Eligibility

To qualify for this deduction, the taxpayer must be a "general partner" of a "qualified venture capital fund" that invested in at least one "Connecticut bioscience business."

General Partner

By law, to qualify for the deduction the general partner must be a:

1. partner of a general partnership;

2. general partner of a limited partnership that is treated as a partnership for federal income tax purposes;

3. partner of a limited liability partnership; or

4. member of a limited liability company (LLC) that is treated as a partnership for federal income tax purposes if (a) the LLC is managed by managers and the member is a member-manager or (b) the LLC is not managed by managers.

General partners of a venture capital fund are responsible for the fund's management. They raise money from investors (who become limited partners), make investment decisions, and help the companies they invest in "exit," (e.g., by acquisition or an initial public offering (IPO)).

Venture Capital Fund

For the purposes of this deduction, a "qualified venture capital fund" it is one that was established on or after January 1, 2018, and meets the definition of a venture capital fund under federal regulations regarding investment advisor registration (CGS § 12-704g(4)).

Under these regulations, a "venture capital fund" is generally a private fund that:

1. represents to investors that it pursues a venture capital strategy;

2. holds at least 80% of its assets in qualifying investments or short-term holdings;

3. does not borrow or otherwise incur leverage in excess of 15% of the fund's aggregate capital contributions and uncalled capital commitments, and then only on a short-term basis;

4. does not provide an investor with redemption rights other than in extraordinary circumstances; and

5. is not registered under the Investment Company Act of 1940 and has not elected to be treated as a business development company (17 C.F.R. 275.203(l)-(1)).

The final rule notice and Securities and Exchange Commission (SEC) guidance provides more information on this definition.

Connecticut Bioscience Business

A Connecticut bioscience business is a business principally located in Connecticut that (1) manufactures pharmaceuticals, medicine, medical equipment, medical devices, and analytical lab equipment; (2) operates medical or diagnostic testing labs; or (3) conducts pure research and development in the life sciences (CGS § 12-704g(2)).

Calculating the Deduction

Generally, the amount of income a general partner may deduct is the sum of the partner's:

1. income received for the tax year from the sale, transfer, exchange or other disposition of the fund's equity interests in Connecticut bioscience businesses (i.e., the carried interest in those investments), and

2. share of the fund's management fees, adjusted based on how much of the fund is invested in Connecticut bioscience businesses (i.e., the fund's "bioscience investment ratio").

Bioscience Investment Ratio

The "bioscience investment ratio" represents the portion of the fund invested in Connecticut bioscience businesses. Specifically, it is the ratio of the fund's investments in Connecticut bioscience businesses to its total capital raised. To determine the portion of management fee income that general partners may deduct, they must multiply the income they received from such fees by the fund's bioscience investment ratio.

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