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SFA BILL ANALYSIS

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Senate Bill 618 (as introduced 7-12-01)
Sponsor: Senator Valde Garcia
Committee: Economic Development, International Trade and Regulatory Affairs

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CONTENT

The bill would create the "Certified Capital Company Act" to provide a 100% single business tax credit to a "certified investor" (an insurance company) that made an investment in a certified capital company. The certified capital company then would have to make qualified investments in a qualified business (a small business concern or a business in an eligible distressed area), according to a schedule and criteria specified in the bill.

The bill would do all of the following:

-- Limit the total credits claimed under the bill by all taxpayers to $200 million.
-- Provide for the Department of Treasury to allocate tax credits.
-- Specify procedures for certification by the Department of a certified capital company, including payment of a $7,500 application fee.
-- Specify a schedule and criteria for a certified capital company's investments, and otherwise regulate certified capital companies.
-- Allow a certified capital company to request a written opinion from the Department as to whether a specific business was a qualified business and request an opinion from the Michigan Economic Development Corporation (MEDC) as to whether a business was an early stage business engaged in high-technology activity or had its principal business operations located in one or more eligible distressed areas.
-- Allow a certified capital company to make a qualified distribution at any time, but restrict other distributions from certified capital.
-- Specify a procedure for decertification of a certified capital company as well as the recapture of tax credits previously claimed and the forfeiture of future tax credits by certified investors in a decertified capital company.
-- Restrict insurers' control over a certified capital company.
-- Allow a certified investor to transfer or sell a vested credit only to another certified investor.

Defined Terms

"Certified capital company" would mean a partnership, corporation, trust, or limited liability company, regardless of whether it was organized on a profit or not-for-profit basis, that had as its primary business activity the investment of cash in qualified businesses and that was certified by the Department of Treasury as meeting the bill's criteria. "Qualified business" would mean a business other than one predominantly engaged in professional services provided by accountants, lawyers, or physicians that, at the time of a request for a written opinion of the Department of Treasury or the MEDC under the bill or, if no request were made, at the time of the initial investment in the business, had its headquarters or principal business operation located in Michigan and was a small business concern as defined in the Code of Federal Regulations (13 CFR 121.201) and/or had its principal business operations located in one or more eligible distressed areas.

"Certified investor" would mean an individual, corporation, association, partnership, or other legal entity that was subject to tax as an insurance company under either the Single

Business Tax Act or the Insurance Code as of the date of its initial investment of certified capital and that invested certified capital pursuant to an allocation of tax credits under the bill. "Certified capital" would mean an investment of cash by a certified investor in a certified capital company that fully funded the purchase price of an equity interest in the company or a qualified debt instrument issued by the company.

Tax Credit

A certified investor that invested certified capital pursuant to an allocation of tax credits under the bill would earn a vested tax credit against its tax liability equal to 100% of its investment. A certified investor would be entitled to take a maximum of 10% of the vested tax credit in any tax year beginning with the year during which the investment was made. The tax credit that could be claimed in any one year could not be more than the certified investor's tax liability for that year. All unused tax credits could be carried forward until they were used up.

The Department of Treasury would have to allocate tax credits in the order in which it received tax credit allocation claims. Within 10 days after receiving a tax credit allocation claim from a certified investor, the Department of Treasury would have to notify that investor of the amount of the tax credits allocated to the investor. If the certified investor did not invest certified capital in a certified capital company within 10 business days after receiving an allocation, the investor would forfeit that portion of the allocation not invested.

A certified investor, on an aggregate basis with its affiliates, could not file tax credit allocation claims for more than 15% of the total maximum aggregate amount of tax credits allowed under the bill or $10 million, whichever was greater.

A certified capital company could file tax allocation claims on behalf of its certified investors at any time after it became certified but not earlier than May 31, 2002. Tax credits could be claimed or otherwise used with respect to tax years beginning on or after January 1, 2002.

A certified investor claiming a credit under the bill would not have to pay any additional tax levied under the Insurance Code as a result of claiming the credit. A certified investor would not be required to reduce the amount of tax pursuant to the Single Business Tax Act included in connection with rate making for any insurance contract written in Michigan because of a reduction in the certified investor's tax based on the credit.

Application for Certified Capital Company

The Department of Treasury would have to begin accepting applications for certification of a certified capital company by October 31, 2001. An applicant would have to pay a nonrefundable application fee of $7,500.

A certified capital company's net worth at the time of seeking certification would have to be at least $500,000, determined by the company's unencumbered cash, marketable securities, and other liquid assets. The Department would have to review each applicant's organizational documents and business history and determine whether the applicant's net worth met that standard.

At least two principals of a certified capital company or a person employed to manage a company's funds would have to have at least two years of experience in the venture capital industry.

Within 30 days of the filing of an application, the Department would have to issues a certification as a certified capital company or refuse to issue a certification. If the Department refused certification, it would have to communicate in detail to the applicant the grounds for the refusal, including suggestions for remediation.

Each certified capital company would have to pay an annual, nonrefundable certification fee of $5,000 to the Department of Treasury.

Certified Capital Company Investments

Within three years after its allocation date, a certified capital company would be required to have made qualified investments cumulatively equal to at least 30% of its certified capital. Within five years, the company would have to have made qualified investments cumulatively equal to at least 50% of its certified capital.

For purposes of satisfying these percentage requirements, the company would be considered to have invested $2 for every $1 invested in a qualified business that had its principal business operations in one or more eligible distressed areas.

All certified capital not placed in qualified investments could be held or invested in a manner that the company considered appropriate. The company could not invest more than 15% of its certified capital in only one qualified business.

("Allocation date" would mean the date on which the certified investors of a certified capital company were allocated tax credits by the Department of Treasury. "Qualified investment" would mean the investment of cash by a certified capital company in a qualified business for the purchase of any debt, equity, or hybrid security, of any nature and description, including a debt instrument, debt participation, or security that had the characteristics of debt but that provided for conversion into equity or equity participation instruments such as options or warrants. "Eligible distressed area" would mean an eligible distressed area as defined in the State Housing Development Authority Act (MCL 125.1411), that was classified as such at the time of a request for a written opinion of the Department of Treasury or the MEDC under the bill or, if no request were made, at the time of the initial investment in the business.)

Each certified capital company would have to report all of the following to the Department of Treasury and to the MEDC:

-- As soon as practicable after receiving certified capital, the name of each certified investor, the amount of each investor's investment and tax credits, and the date on which the capital was received.
-- By January 31 of each year, the amount of the company's certified capital at the end of the preceding calendar year; whether the company had invested more than 15% of its total certified capital in any one business; a description of all qualified investments that the company made during the preceding calendar year; a description of all investments in early stage businesses engaged in high-technology activity made during the preceding calendar year; and a description of all investments in qualified businesses with principal business location in one or more eligible distressed areas made during the preceding calendar year.
-- Within 90 days after the close of each fiscal year, an audited financial statement that included the opinion of an independent certified public accountant (CPA), and a report prepared by the CPA addressing the methods of operation and conduct of the business of the company to determine if it was in compliance with applicable statutes and rules and that the funds it received had been invested as required under the bill.
-- By January 31 of each year, an annual report of the economic impact of the company's investments in the preceding calendar year with specific identification of the investment in qualified businesses engaged in high-technology activity or with principal business operation in one or more eligible distressed areas.

"Early stage business" would mean a business that, at the time of a request for a written opinion of the Department of Treasury or the MEDC under the bill or, if no request were made, at the time of the initial investment in the business, met one or more of the following conditions:

-- The business was engaged in activities related to the development of initial product or service offerings.
-- The business was less than two years old.
-- During the fiscal year preceding the request for a written opinion of the Department or the MEDC under the bill or, if no request were made, during the fiscal year preceding the initial investment in the business, it had gross revenues of no more than $3 million calculated on a consolidated basis according to generally accepted accounting principles.

"High technology activity" would mean one or more of the following:

-- Advanced computing, which would be any technology used in the design and development of computer hardware and software, data communications, or information technologies.
-- Advanced materials, which would be materials with engineered properties created through the development of specialized process and synthesis technology.
-- Biotechnology, which would be any

technology that used living organisms, cells, macromolecules, microorganisms, or substances from living organisms to make or modify a product, improve plants or animals, or develop microorganisms for useful purposes. Biotechnology would not include human cloning.
-- Electronic device technology, which would be any technology that involved microelectronics, semiconductors, electronic equipment, and instrumentation, radio frequency, microwave, and millimeter electronics, and optical and optic-electrical devices, or data and digital communications and imaging devices.
-- Engineering or laboratory testing related to the development of a product.
-- Technology that assisted in the assessment or prevention of threats or damage to human health or the environment, including environmental cleanup technology, pollution prevention technology, or development of alternative energy sources.
-- Medical device technology, which would be any technology that involved medical equipment or products, other than a pharmaceutical product, that had therapeutic or diagnostic value and was regulated.
-- Product research and development.
-- Advanced vehicles technology that was any technology involving electric vehicles, hybrid vehicles, or alternative fuel vehicles, or components used in their construction.

Investments: Written Opinion

Before making a proposed investment in a specific business, a certified capital company could request a written opinion from the Department of Treasury as to whether the business was a qualified business and an opinion from the MEDC as to whether the business was an early stage business engaged in high-technology activity or had its principal business operations located in one or more eligible distressed areas.

The Department or the MEDC, as applicable, would have to notify the company of its opinion within 10 days after the request was made. If the Department or the MEDC determined that a business did not meet those definitions, it would have to provide an explanation of its determination. If the Department or the MEDC failed to respond within 10 days, the business would be considered to be a qualified business or an early stage business engaged in high-technology activity, or to have its principal business operations located in an eligible distressed area, as applicable.

The Department could determine that a business was a qualified business or the MEDC could determine that a business was an early stage business engaged in high-technology activity, even if the business did not meet either definition in the bill, if the Department or the MEDC determined that an investment in the business by a certified capital company would further economic development in Michigan.

Qualified Distributions

A certified capital company could make a qualified distribution at any time. In order to make a distribution or payment from certified capital, other than a qualified distribution or a payment to debt holders, a certified capital company would have to have made qualified investments in an amount cumulatively equal to at least 100% of its certified capital with at least 20% of its certified capital invested in early stage businesses engaged in high-technology activity.

("Qualified distribution" would mean a distribution or payment by a certified capital company from certified capital in connection with any of the following:

-- Reasonable costs and expenses of forming and syndicating the company.
-- Reasonable costs and expenses of managing and operating the company, including an annual management fee 2.5% of the company's certified capital.
-- Any projected increase in Federal or State taxes, including penalties and interest related to income taxes, of the company's equity owners company resulting from the earnings or other tax liability of the company or the equity owners to the extent that the increase was related to the ownership, management, or operation of the company or the issuance, repayment, or redemption of its qualified debt instruments.)

Payments to debt holders could be made without restriction with respect to repayments

of principal and interest owed, including indebtedness on which certified investors earned tax credits. A debt holder that also was a certified investor or equity holder could receive payments with respect to the debt without restrictions.

The Department of Treasury annually would have to determine whether the aggregate total of distributions from certified capital, excluding qualified distributions, to each certified capital company's certified investors and equity holders, when combined with all tax credits allocated to and used by the certified investors, resulted in an annual internal rate of return that exceeded 15% on the certified capital allocated to the certified investors plus any additional capital contributions to the company. If, as of the date of that determination, the company's annual internal rate of return exceeded 15%, the company would have to pay to the Department an amount equal to 30% of any subsequent distributions from the certified capital, other than qualified distributions, above the amount required to produce a 15% return.

Decertification, Recapture, and Forfeiture

The Department of Treasury would have to conduct an annual review of each certified capital company to determine if it was abiding by the certification requirements, to advise the company as to the eligibility status of its qualified investments, and to ensure that its investments were not in violation of the bill. The Department could not charge more than $5,000 for the review and would have to be paid by each certified capital company.

Any material violation of the bill regarding a certified capital company's investments would be grounds for decertification. If the Department determined that a company was not in compliance with the bill's provisions pertaining to investments, the Department, by written notice, would have to inform the company's officers that it could be subject to decertification in 120 days unless the deficiencies were corrected. At the end of the 120-day period, if the company were still not in compliance with the bill, the Department could send a notice of decertification to the company and to all other appropriate State agencies.

Decertification could cause the recapture of tax credits previously claimed and the forfeiture of future tax credits to be claimed by certified investors. Decertification before the company had made qualified investments of 30% of its certified capital within three years would cause the recapture of all tax credits previously claimed and the forfeiture of all future tax credits to be claimed by certified investors. If, after initial certification, a company failed to have made qualified investments of 50% of its certified capital within five years after having met the 30%-in-three-years requirement, the first 30% of vested tax credits that could be claimed by each certified investor would not be subject to recapture or forfeiture. The remainder of the vested tax credits of each certified investor, however, would be subject to recapture or forfeiture. If a company met the 50%-in-five-years requirement, and subsequently were decertified, the first 50% of the vested tax credits would not be subject to recapture or forfeiture but the remainder of the tax credits would be.

If a certified capital company had invested an amount cumulatively equal to 100% of its certified capital in qualified investments, all tax credits claimed or to be claimed by its certified investors would no longer be subject to recapture or forfeiture. If a company had invested an amount cumulatively equal to 100% of its certified capital in qualified investments and had met all other requirements under the bill, the company would no longer be subject to the bill or to regulation by the Department of Treasury.

Insurers

Under the bill, an insurer or any affiliates of an insurer could not do any of the following:

-- Directly or indirectly beneficially own, whether through rights, options, or convertible interests, 10% or more of a certified capital company's equity securities.
-- Manage a certified capital company.
-- Control the direction of investments for a certified capital company.

Those restrictions, however, would not preclude a certified investor or any other person from exercising its legal rights and remedies, including interim management of a

certified capital company in the event that a company was in default of its statutory or contractual obligations.

Legislative Analyst: P. Affholter

FISCAL IMPACT

No reasonable estimate of the fiscal impact of this bill can be made at this time, because there are too many unknown factors. The key unknown factors include: 1) the number of businesses that would qualify as certified investors, 2) the amount these certified investors would invest in qualified activities, and 3) whether these investments would occur anyway without this new proposed tax credit. Although the bill would limit the total amount of tax credits to $200 million, but there is no way to know how much of these credits would be claimed in any one year, or how many years it would take for these credits to be fully claimed.

An application fee of $7,500 would be charged to capital companies applying for certification. Once approved, a $5,000 annual fee would be imposed on each certified capital company to continue its certification status. In addition, the Department of Treasury could assess a fee of up to $5,000 to conduct an annual certification review of each certified capital company. The collected fees would benefit the General Fund and the revenue collected would depend upon how many companies would be certified and require a review.

Implementation of this bill would require a new review and approval function of the Department of Treasury. Since the number of applications that would be received is unknown, the potential staffing needs of the Department are indeterminate.

The bill also would increase the administrative responsibilities of the MEDC by requiring it to publish opinions on the status of certain companies with no clear revenue source to support these activities.

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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.