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BILL



ANALYSIS

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Senate Bill 834 (Substitute S-3 as reported)
Senate Bills 835 and 836 (as reported without amendment)
Sponsor: Senator Michael D. Bishop (Senate Bill 834)
Senator Tom George (Senate Bill 835)
Senator Nancy Cassis (Senate Bill 836)
Committee: Commerce and Labor

Date Completed: 11-25-03

RATIONALE

A key element in fostering economic development and promoting job creation is the availability of capital investment in early-stage small businesses. Venture capital firms (businesses that offer financial and strategic planning resources to young companies) often are the source of this type of investment. Apparently, this financial support has been lacking in Michigan. The State is said to rank low in the amount of venture capital available to start-up companies in Michigan, and even lower in the amount actually invested in them. Also, much of the money that is raised evidently ends up invested in out-of-State interests. In order to assure that venture capital companies develop and remain in Michigan and that their investments go to in-State businesses, some people believe that Michigan should establish a nonprofit corporation that, through guaranteed returns or tax credits, would foster investment in venture capital firms, which, in turn, would invest in Michigan start-up companies.

CONTENT

Senate Bill 834 (S-3) would create the "Michigan Early Stage Venture Capital Investment Act" to require that, within one year after the bill's effective date, the "Michigan Early Stage Venture Capital Investment Corporation" be established, a fund manager be hired, an investment plan be established, and funds be solicited and available for investment consistent with that plan. The Corporation would have to create the "Michigan Early Stage Venture Capital Investment Fund". Money in the Fund could be invested in venture capital

companies to promote investment in qualified businesses.

If the Fund could not repay the negotiated return on a person's investment, the Corporation would have to give the investor a certificate for a single business tax (SBT) or income tax credit for the difference between the amount repaid by the Fund and the negotiated repayment amount. The credit would be a debt of the Fund to the Department of Treasury. The Fund would expire on January 1, 2054, and its balance would be transferred to the State's General Fund.

Senate Bill 835 would amend the Single Business Tax Act to specify that, for tax years beginning after 2008 and before 2020, a taxpayer that was an investor could claim an SBT credit equal to the amount determined and certified under Senate Bill 834. For tax years beginning after 2009, if a credit against the SBT or a successor tax were not allowed, the taxpayer could transfer the credit to a person who could claim an income tax credit (under Senate Bill 836). The total amount of all certified SBT credits for all taxpayers for all years could not exceed \$150 million. The total amount of all credits authorized for any one year could not exceed \$30 million.

Senate Bill 836 would amend the Income Tax Act to provide that, for tax years beginning after 2009 and before 2020, a taxpayer to whom a certificate and remaining SBT credit amount had been

transferred under Senate Bill 835 could claim that credit against the income tax.

Senate Bill 834 (S-3) would define "venture capital company" as a corporation, partnership, or other legal entity whose primary business activity was the investment of equity capital in businesses that focus on areas including, but not limited to, alternative energy technology, high-technology activity, or health care. "Qualified business" would mean a seed or early stage business that was located in Michigan, that had its corporate headquarters in Michigan, or the majority of whose employees worked a majority of their time as a site located in Michigan. "Seed or early stage business" would mean a business that had less than \$15 million in gross receipts and fewer than 200 employees for the calendar year immediately preceding initial investment in the business by a venture capital company.

Senate Bill 834 (S-3) is tie-barred to Senate Bills 835 and 836, which are tie-barred to Senate Bill 834.

Senate Bill 834 (S-3)

Early Stage Venture Capital Investment Corporation

The Michigan Early Stage Venture Capital Investment Corporation would have to be incorporated as a nonprofit corporation or be a governmental agency under the Internal Revenue Code by July 1, 2004. The Corporation would be a charitable and benevolent institution and its funds and property would be exempt from State and local taxes.

The bill would require that the Corporation's articles of incorporation contain its purposes, including to "operate and act for charitable purposes with the intent to lessen the state's financial burdens"; to receive and administer funds for charitable purposes; to raise capital and invest it in venture capital firms to benefit Michigan's early stage, growth companies; to promote Michigan's economic health by assisting in creating new jobs, businesses, and industries and through investment in certain businesses; and to enter into an agreement with the State to promote Michigan's economic health.

The Corporation would be subject to the Open Meetings Act. Information received, prepared,

used, or retained by the Corporation that was confidential financial or proprietary information would not be subject to the Freedom of Information Act.

Early Stage Venture Capital Investment Fund

The Corporation would have to create the Michigan Early Stage Venture Capital Investment Fund, which would be a restricted fund. With the approval of the Corporation's board of directors, the fund manager would have to establish an investment plan for the money in the Fund.

Up to 15% of the Fund's total capital and outstanding commitments could be invested in any single venture capital company. The fund manager, with the approval of the board, would have to invest the Fund to "promote" that at least \$2 would be invested in qualified businesses for every \$1 of principal guaranteed by the State as tax credits available under Senate Bills 835 and 836.

Fund investments would have to facilitate the transfer of technologies from the State's universities and research institutions. In addition, priorities for investment in venture capital could be based on an evaluation, which would have to consider the retention of businesses that would be likely to leave Michigan without the investment, the revitalization and diversification of Michigan's economic base, and the generation and retention of jobs and investment in Michigan.

The fund manager would have select venture capital companies considering the following criteria:

- The company's probability of success in generating above-average returns through investing in qualified businesses.
- The company's probability of success in soliciting investments.
- The company's probability of success regarding the criterion that \$2 be invested for every \$1 guaranteed by the State as tax credits.
- The company had a significant presence in Michigan, as determined by the Corporation.
- The company's consideration of minority-owned businesses in its investment activities.

Investment from the Fund committed to a venture capital company could not be more

than 25% of the company's total capital under management.

Investor Agreements/Tax Credits

To secure investment in the Fund, the Corporation would have to enter into agreements with investors. Each agreement would have contain all of the following:

- An established and agreed-upon investment amount and repayment schedule.
- A guaranteed negotiated amount or negotiated return on investment over the term of the agreement.
- A maximum amount of credit that the investor could claim under Senate Bill 835 or 836 and the first year in which a credit could be claimed.

The Fund would have to repay any amounts due from proceeds of the money raised based on the investor agreements.

For tax years beginning after December 31, 2008, an investor that had a certificate could claim a tax credit under Senate Bill 835 or 836 that was equal to the difference between the amount actually repaid and the amount set in the agreement as the repayment due. The amount of the credit would become a guarantee of repayment and a debt of the Fund to the Department of Treasury, subject to repayment pursuant to the agreement between the Corporation and the Department. The debt would accrue interest at the same rate as the interest paid to the investor. The guarantee would not be an obligation of the State and could be restricted to specific funds or assets of the Corporation.

Tax Credit Certificates

The Corporation would have to determine which investors were eligible for SBT credits under Senate Bill 835 and income tax credits under Senate Bill 836, and the amount of the tax credit allowed to each investor. The Corporation would have to submit proposed tax credit certificates to the Department of Treasury. The Department would have to approve or deny a proposed certificate within 30 days after receiving it, and notify the Corporation and the investor of the reason for a denial. The Corporation subsequently could submit another proposed certificate on behalf of that investor.

The Corporation would have to issue to each investor a certificate, showing the amount of the credit, the tax years for which it could be claimed, and the maximum annual amount that could be claimed each tax year. A certificate would have to be issued at the time the Corporation determined that, for that investor, capital was not sufficient to meet the guaranteed negotiated amount or the negotiated return on the investor's qualified investment. The total of all certificates issued could not exceed the maximum amount allowed under Senate Bill 835.

The fund manager would have to invest, budget, and plan scheduled payments and repayments so that no credits were claimed under Senate Bill 835 in any tax year before those beginning after December 31, 2008.

Application for Registration

Before a nonprofit corporation applied for registration as the Michigan Early Stage Venture Capital Investment Corporation, it would have to submit its articles of incorporation to the Attorney General for review and certification. If the submitted information complied with the bill's requirements, the Attorney General would have to issue a certificate of compliance upon the payment of a \$100 fee. The State Treasurer would have to examine the registration application and could conduct an investigation, request additional information, or examine under oath anyone interested in or connected with the nonprofit corporation. The State Treasurer would have to register the nonprofit corporation if the application documents were in the proper form, the articles of incorporation met the bill's requirements, and the IRS had determined that the nonprofit corporation was exempt from taxation or was a governmental agency under the Internal Revenue Code.

Board of Directors

Membership. The Michigan Early Stage Venture Capital Investment Corporation would be governed by a board of directors consisting of five members appointed by the Governor, including the State Treasurer or his or her designee, the chief executive officer of the Michigan Economic Development Corporation (MEDC) or his or her designee, one person recommended by the Senate Majority Leader, one person recommended by the Speaker of the House, and one person recommended by

a statewide tax-exempt organization whose members represented more than 50% of the venture capital companies in Michigan. The recommended board members would serve three-year staggered terms.

Conflict of Interest. The bill would prohibit a director, employee, or agent of the board from engaging in any conduct that would constitute a conflict of interest. A director, employee, or agent immediately would have to advise the board of the any incident or circumstance that could present a conflict of interest. A director who had a conflict of interest on any matter would have to refrain from voting on it, participating in discussions and deliberations on the matter, or being present at a meeting at which discussion, deliberation, and voting on the matter occurred. A director's failure to comply with those requirements would constitute misconduct in office and the director could be removed from the board by a majority vote of the remaining directors.

Fiduciary Duties. Each director would have to exercise the duties of a fiduciary and discharge his or her duties with the degree of diligence, care, and skill that an ordinarily prudent person would exercise under the same or similar circumstances in a like position. A director could be removed from the board for a breach of fiduciary duty by a vote of the remaining directors.

Liability/Indemnification. A director or an officer or employee of the board or the Corporation would not be subject to personal liability when acting in good faith within the scope of his or her authority or on account of liability of the Corporation, and the board could defend and indemnify a director, officer, or employee against liability arising out of the discharge of his or her official duties. Also, the Corporation could indemnify and procure insurance indemnifying directors, officers, and employees from personal loss or accountability for liability regarding actions of the board or the failure of the board or Corporation to act.

Corporation Duties & Responsibilities

The Michigan Early Stage Venture Capital Investment Corporation could perform or delegate any act consistent with the proposed Act and the purposes of the nonprofit corporation, including:

- Entering into contacts and all necessary activities of the Corporation.

- Charging reasonable fees for the implementation of the Act and the ongoing operation of the Corporation.
- Performing acts or entering into transactions necessary to carry out the Corporation's powers and duties.
- Employing a fund manager and others the Corporation considered necessary to implement the Act.

Annual Report

The Corporation would have to publish an annual report within three months after the close of its fiscal year. The report would have to include an enumeration of all investments and related activities for that fiscal year and documentation and analysis of the implementation and status of the Corporation's investment plan and the plan's economic impact on the State. The documentation and analysis would have to include both of the following:

- The number of jobs represented by the investments made in qualified businesses in Michigan.
- Return on investment generated by investment, the types of activities in which investment was made, and the impact of that investment on Michigan's economic base.

Senate Bill 835

For tax years beginning after December 31, 2008, and before January 1, 2020, a taxpayer that was an investor could claim an SBT credit equal to the amount determined and certified under the proposed Michigan Early Stage Venture Capital Investment Act.

The credit allowed for any tax year could not exceed the difference between the amount actually repaid and the amount set as the repayment due in an agreement entered into by the taxpayer and the Michigan Early Stage Venture Capital Investment Corporation under the proposed Act. If a taxpayer's credit for a tax year exceeded the taxpayer's tax liability for that tax year, the excess portion of the credit would have to be refunded.

For tax years beginning after December 31, 2009, if an SBT credit were not allowed against the taxpayer's tax liability under the SBT Act or against any successor tax to the SBT, a taxpayer could transfer the certificate and the credit to a person who could claim the

credit against the income tax, as provided in Senate Bill 836.

Senate Bill 836

For tax years beginning after December 31, 2009, and before January 1, 2020, a taxpayer to whom a certificate and remaining credit amount were transferred under Senate Bill 835 could claim that credit against the income tax in an amount equal to the transferred credit.

An income tax credit could be claimed only in a tax year in which the credit against the SBT under Senate Bill 835, or against a successor tax to the SBT, was not allowed. The income tax credit allowed for any tax year could not exceed the amount transferred and allowed on the certificate. If the taxpayer's credit for a tax year exceeded his or her tax liability for that year, the excess portion of the credit would have to be refunded.

Proposed MCL 208.37e (S.B. 835)
Proposed MCL 206.270 (S.B. 836)

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

Positioning Michigan for a future of economic growth and diversity depends on the development of new and progressive businesses in the State. By providing for the creation of a nonprofit corporation that would oversee a venture capital fund supported by private investment, the bills would help to foster economic development in Michigan, particularly in high-tech industries. Guaranteeing a rate of return or SBT credits to investors would provide an incentive for established Michigan businesses to invest in small, Michigan-based companies at an early stage of their development. That investment of venture capital, in turn, would create much-needed new jobs in the State: According to the Michigan Venture Capital Association, a new job is created with every \$21,627 of venture capital invested. This type of investment, then, should spur business growth, economic diversification, and employment that would both benefit Michigan's economy and enhance the State's tax revenues.

Response: From the defined terms in Senate Bill 834 (S-3), it appears that money invested in the proposed Fund and then invested in venture capital companies would not necessarily be targeted toward new, small, or high-technology companies. The bill's definition of "venture capital company" (in which the Fund would invest) refers to a business that invests equity capital in areas that include--but are not limited to--alternative energy technology, high-technology activities, or health care, while its definition of "seed or early stage business" (in which the venture capital companies would invest Fund money) refers only to a business with less than \$15 million in gross receipts and fewer than 200 employees.

Supporting Argument

Michigan reportedly has not performed well in providing venture capital for business development in the State. According to testimony before a Senate committee on a similar bill in the 2001-02 legislative session, Michigan ranked 44th among the 50 states in the amount of venture capital available to start-up companies and even lower in the amount of venture capital actually invested within the State. Apparently much of the venture capital raised in Michigan ends up being funneled into out-of-State business development interests. By providing for a system under which venture capital would be invested in Michigan-based companies, the bills should keep much of that money in the State and improve Michigan's standing as a location that is friendly to new business development. The bills also would help to draw business development interests from outside the State.

Opposing Argument

Although the capital investment system proposed by Senate Bill 834 (S-3) could benefit the State's economy in the long run, the proposal comes at a bad time. Since the State is once again facing a major budget shortfall and must reduce and eliminate programs and/or raise revenue, the State cannot afford to offer an SBT credit to businesses that invested in the proposed Fund.

Response: The Fund would consist of investment from private interests, not State tax dollars. Also, while the private investment in the Fund at a negotiated rate of return would occur soon after the Fund's creation, investors could not claim an SBT credit until the 2009 tax year. In addition, if the Fund's

investments realized the anticipated level of success, the tax credits would never have to be claimed. The credits would apply only if an investor did not receive its negotiated rate of return based on the Fund's performance. If Fund investments in venture capital companies were successful in developing new industries and businesses in Michigan, the rate of return to the Fund on those investments should be sufficient to repay the initial investors. According to testimony before the Senate Committee on Commerce and Labor by a Department of Treasury official, Oklahoma has a venture capital investment system similar to that proposed by Senate Bill 834 (S-3) and has not had to issue any tax credits to the initial investors. Even if the State had to issue tax credits between 2009 and 2020, the amount of those credits would constitute a debt of the Fund to the State, so any cost to the State in the form of tax credits eventually would have to be repaid, with interest, by the Fund. In the very long run, the balance of the Fund would revert to the State in 2054, so the system proposed by the bills should end up being a money-maker for the State. In fact, the Michigan Venture Capital Association has estimated that this proposal could result in the creation of over 6,000 new jobs and generate over \$100 million for the State.

Opposing Argument

Having the State provide a guarantee for private investors in new firms is a bad idea. Although the development of new businesses can aid the economy and generate jobs, start-up firms tend to have a high failure rate. Investing in those companies can be very risky, but investors may reap a very good return when the companies do succeed. That is why the reward for successful venture capital investments is called the "risk premium". Under the system proposed by the bills, however, the State's taxpayers would assume the risk, while private investors in the Fund would retain the premium, through a guaranteed rate of return.

Opposing Argument

Although creating a Fund to invest in various venture capital companies could prove fruitful, there are some deficiencies in the bills. Since the Corporation would be a major tool in the State's economic development and could significantly affect tax policy, its board of directors should have more executive branch accountability. While the board would include the State Treasurer and the chief executive officer of the MEDC, they would constitute a

minority of the board's five members. In addition, while the proposed income tax credit is included in the legislation because the SBT is scheduled to expire at the end of 2009, allowing SBT credits to be transferred to income tax liability could provide a windfall to some individuals. There should be an alternative mechanism for the credits to continue beyond the SBT's expiration. Also, while the bills would require that tax credit certificates be issued when an investor's negotiated rate of return was not realized, investors might feel more secure if tax credit certificates were offered up-front, at the time of their initial investment in the Fund.

Legislative Analyst: Patrick Affholter

FISCAL IMPACT

It is not possible to provide a meaningful estimate of the fiscal impact of these bills because there are too many unknown factors. For example, there is no way to know, 1) how much investors would be willing to invest in this type of investment fund, 2) the rate of return that would be guaranteed to individual investors, 3) the ultimate actual rate of return that would be realized by this fund, or 4) the amount that investors would be eligible to claim as refundable credits against the single business tax or income tax, if the actual rate of return turned out to be less than the guaranteed rate of return. The only thing known for sure is that under these bills, the total credits paid to investors could not exceed \$30 million in any one year and \$150 million during the life of the fund, and investors could not claim these credits until 2009. While the bills would require the fund to repay the State for all the tax credits claimed by investors, the timing of these repayments is unclear. As a result, the maximum initial cost to the State would be \$30 million in any given year and \$150 million over the life of the fund, and the earliest this initial cost could be incurred would be FY 2009-10; however, over the longer term, the maximum potential cost to the State would probably be much less, or even zero, assuming the fund would eventually repay the State, with interest, for some or all of the credits paid to investors.

Fiscal Analyst: Jay Wortley
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