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BILL ANALYSIS

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Senate Bills 834 and 835 (as enrolled)
House Bill 5322 (as enrolled)
Sponsor: Senator Michael D. Bishop (S.B. 834)
Senator Tom George (S.B. 835)
Representative Fran Amos (H.B. 5322)
Senate Committee: Commerce and Labor
House Committee: Commerce

PUBLIC ACTS 296 & 297 of 2003
PUBLIC ACT 295 of 2003

Date Completed: 1-4-05

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, 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, it was suggested that Michigan 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 created the Michigan Early Stage Venture Investment Act to require that, within one year after the bill's effective date or 10 months after IRS approval of tax-exempt status, whichever is later, the Michigan Early Stage Venture 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 must create the Michigan Early Stage Venture Investment Fund. Money in the Fund may be invested in venture capital companies to promote investment in qualified businesses.

If the Fund cannot repay the negotiated return on a person's investment, the Corporation must 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 will be a debt of the Fund to the Department of Treasury. The Fund will expire on January 1, 2054, and its balance must be transferred to the State's General Fund.

Senate Bill 835 amended the Single Business Tax Act to specify that, for tax years beginning after 2008 and before 2020, a taxpayer that is an investor may 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 is not allowed, a taxpayer to whom a credit was issued under Senate Bill 834 may claim an income tax credit (under House Bill 5322) or transfer that SBT credit certificate as allowed under House Bill 5322. The total amount of all certified SBT credits for all taxpayers for all years may not exceed $150 million. The total amount of all credits authorized for any one year may not exceed $30 million.

House Bill 5322 amended 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 have been transferred under Senate Bill 835 may

claim that credit against the income tax, or the claimant may claim an income tax credit.

Senate Bill 834 defines "venture capital company" as a corporation, partnership, limited liability company, or other legal entity whose primary business activity is 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. An "investor" is an individual or entity that invests in the Early Stage Venture Investment Fund.

"Qualified business" means a seed or early stage business that is domiciled in Michigan, that has its corporate headquarters in Michigan, or the majority of whose employees work a majority of their time as a site located in Michigan. "Seed or early stage business" means either a business that has not fully established commercial operations and may also be engaged in continued research and product development, or a business that is engaged in product, service, or technology development and initial manufacturing, marketing, or sales activity.

The bills took effect on January 8, 2004. Senate Bill 834 was tie-barred to Senate Bills 835 and House Bill 5322, which were tie-barred to Senate Bill 834.

Senate Bill 834

Early Stage Venture Investment Corporation

The Michigan Early Stage Venture Investment Corporation must be incorporated as a nonprofit corporation that, by September 1, 2004, has received a favorable determination from the Internal Revenue Service that the corporation is a nonprofit corporation exempt from taxation under the Internal Revenue Code (IRC). (The Department of Treasury may allow up to three 30-day extensions for purposes of reviewing and approving a registration application.)

The bill requires 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 seed or early stage businesses; 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 articles also must provide that, upon the Corporation's dissolution, the property remaining after providing for debts and obligations of the Corporation must be distributed to an organization that either qualifies as a governmental unit or is tax-exempt under the IRC, as designated by the Corporation's board of directors. If the board fails to designate an organization, the remaining property must pass to the State. For the purpose of these requirements, property remaining after providing for debts and obligations does not include grants, appropriations, or other restricted funds that must be distributed as required by the source of those funds.

Early Stage Venture Investment Fund

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

Up to 15% of the Fund's total capital and outstanding commitments may be invested in any single venture capital company. The Fund manager, with the approval of the board, must invest the Fund to "promote" that at least $2 will be invested in qualified businesses for every $1 of principal guaranteed by the State as tax credits available under Senate Bill 835 and House Bill 5322.

Fund investments must facilitate the transfer of technologies from the State's universities and research institutions. In addition, priorities for investment in venture capital may be based on an evaluation, considering 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 must 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 has a significant presence in Michigan, as determined by the Corporation.
- -- The company will undertake to invest in qualified businesses, as determined at the point of initial investment, a percentage of invested capital at least matching the percentage of invested capital that the company received from the Fund.
- -- The company's consideration of minority-owned businesses in its investment activities.

Investment from the Fund committed to a venture capital company may not exceed 25% of the company's total capital under management.

Investor Agreements/Tax Credits

To secure investment in the Fund, the Corporation must enter into agreements with investors. Each agreement must 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 may claim under Senate Bill 835 or House Bill 5322 and the first year in which a credit may be claimed.

The Corporation must notify the Department of Treasury when investor agreements are entered into and must send a copy of each agreement to the Department. The Department must issue to the investor an approval letter stating that the investor is entitled to a tax credit under Senate Bill 835 or House Bill 5322.

For tax years beginning after December 31, 2008, an investor that has a certificate may claim a tax credit under Senate Bill 835 or House Bill 5322 that is 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 will become a debt of the Fund to the State, subject to repayment pursuant to the agreement between the Corporation and the Department. The debt will accrue interest at the same rate as the interest paid to the investor. Repayment of a debt may be restricted to specific funds or assets of the Corporation.

Tax Credit Certificates

The Corporation must determine which investors are eligible for SBT credits under Senate Bill 835 and income tax credits under House Bill 5322, and the amount of the tax credit allowed to each investor. The Corporation must submit proposed tax credit certificates to the Department of Treasury. The Department must 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. If not approved or denied in that time, a certificate will be considered approved. If a certificate is denied, the Corporation subsequently may submit another proposed certificate on behalf of that investor.

The Corporation must issue to each investor an approved certificate that states all of the following:

- -- That the taxpayer is an investor.
- -- The taxpayer's Federal employer identification number or the SBT taxpayer number assigned by the Department of Treasury.
- -- The amount of the tax credit that the taxpayer may claim under Senate Bill 835 or House Bill 5322.
- -- The tax years for which a credit may be claimed and the maximum annual amount that may be claimed.
- -- That the tax credit is refundable.

A certificate must be issued to an investor at the time the Corporation determines that capital is not sufficient to meet that investor's guaranteed negotiated amount or the negotiated return on the investor's qualified investment. Certificates may not be issued until December 31, 2008, or five years after the bill's requirements for creation and operation of the Corporation and Fund are met, whichever occurs later.

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

Application for Registration

Before a nonprofit corporation applies for registration as a Michigan Early Stage Venture Investment Corporation, it must submit its articles of incorporation to the Attorney General for review and certification. If the submitted information complies with the bill's requirements, the Attorney General, within 60 days after receiving the information, must issue a certificate of compliance upon the payment of a $100 fee.

To apply for registration, the nonprofit corporation must pay a $500 fee and submit all of the following to the State Treasurer:

-- A copy of its articles of incorporation and bylaws.
-- The certificate of compliance issued by the Attorney General (unless the Attorney General does not issue a certificate within the time required).
-- A general plan of the nonprofit corporation's proposed activities, including establishment of the Michigan Early Stage Venture Investment Fund.
-- A copy of the corporation's financial statements for its first fiscal year.

The State Treasurer must examine the registration application and may conduct an investigation, request additional information, or examine under oath anyone interested in or connected with the nonprofit corporation. The State Treasurer must register the nonprofit corporation if the application documents are in the proper form, the articles of incorporation meet the Act's requirements, the plan and proposed activities meet the Act's purposes and requirements, and the IRS has determined that the nonprofit corporation is exempt from taxation under the IRC.

Board of Directors

Membership. The Michigan Early Stage Venture Investment Corporation must be governed by a board of directors consisting of seven members, including the State Treasurer or his or her designee and the chief executive officer of the Michigan Economic Development Corporation (MEDC) or his or her designee. The other five members must be appointed by the Governor, with the advice and consent of the Senate, as follows:

-- One person appointed from a list of at least three names recommended by the Senate Majority Leader.
-- One person appointed from a list of at least three names recommended by the Speaker of the House.
-- One person appointed from a list of one or more names recommended by a statewide tax-exempt organization whose members represent more than 50% of the venture capital companies in Michigan.
-- Two people, representing the general public, with the requisite knowledge and experience in finance and business investment.

Conflict of Interest. The bill prohibits a director, employee, or agent of the board from engaging in any conduct that constitutes a conflict of interest. A director, employee, or agent immediately must advise the board of any incident or circumstance that may present a conflict of interest with respect to the performance of Board-related work or duty of the director, employee, or agent. A director who has a conflict of interest related to any matter before the board must disclose the conflict before the board takes any action on the matter. The director also must refrain from voting on it, participating in discussions and deliberations on the matter, being present at a meeting at which discussion, deliberation, and voting on the matter occur, and discussing the matter with any other board member. A director's failure to comply with those requirements constitutes misconduct in office and the director may be removed from the board by a majority vote of the remaining directors.

Fiduciary Duties. Each director must exercise the duties of a fiduciary toward the Corporation 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 may 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 is not 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 may defend and indemnify a director, officer, or employee against liability arising out of the discharge of his or her official duties. Also, the Corporation may 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 the Corporation to act.

Corporation Duties & Responsibilities

The Michigan Early Stage Venture Investment Corporation may perform or delegate any act consistent with the 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.
-- Investing in venture capital funds through equity securities.
-- Employing a Fund manager and others the Corporation considers necessary to implement the Act.

Annual Report

The Corporation must publish an annual report within three months after the close of its fiscal year. The report must 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 must 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.

Legislative Findings & Purposes

The bill includes the following legislative findings:

-- "There exists a need to promote the economic health of this state by assisting in the creation of new jobs, new businesses, and new industries within this state and through the investment in certain businesses that focus on areas including, but not limited to, alternative energy technology, high-technology, and health care."
-- "Investing in businesses that are early stage growth companies and promoting economic growth in the state to assist the state in carrying out its essential governmental functions and as such are essential public purposes."
-- "Investments in certain businesses promote the retention of businesses and jobs that would be likely to leave the state absent the investment, revitalize and diversify the economic base of this state, generate and retain jobs and investment in this state, and help to effectuate legislative and governmental programs to promote economic growth in this state."
-- "Agreements with private corporations such as Michigan early stage venture investment corporations can assist the state by raising capital and investing that capital in venture capital firms with the intent to benefit this state's early stage growth companies thus facilitating economic growth and development and other government programs and supporting essential public purposes."

The bill also declares that the purposes of the Act are the following:

-- "To promote a healthy economic climate in this state by fostering job creation, retention, and expansion through the promotion of investment in certain businesses."
-- "To allow the state to enter into agreements with Michigan early stage venture investment corporations to promote a healthy economic climate in this state."

Senate Bill 835

The bill provides that, for tax years beginning after December 31, 2008, and before January 1, 2020, a taxpayer that is an investor may claim an SBT credit equal to the amount determined and certified under the Michigan Early Stage Venture Investment Act.

The credit allowed for any tax year may 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 Investment Corporation. If a taxpayer's credit for a tax year exceeds the taxpayer's tax liability for that tax year, the excess portion of the credit must be refunded.

For tax years beginning after December 31, 2009, if an SBT credit is not allowed against the taxpayer's tax liability under the SBT Act or against any successor tax to the SBT, a taxpayer may claim an income tax credit under House Bill 5322 or transfer the certificate and the credit to a person who may claim the credit against the income tax, as provided in House Bill 5322.

House Bill 5322

The bill provides that for tax years beginning after 2009 and before 2020, a taxpayer to whom a certificate and remaining credit amount have been transferred under the SBT Act (pursuant to Senate Bill 835) may claim that credit against the income tax equal to the credit amount transferred, and a "claimant" may claim a credit as provided in the bill. (A "claimant" is a person to whom a certificate for a tax credit has been issued under the Michigan Early Stage Venture Investment Act.)

A credit may be claimed under the bill only in a tax year in which the credit under Senate Bill 835 is not allowed against the SBT or a successor tax, and only in a tax year beginning after December 31, 2009, and before January 1, 2020. If the income tax credit exceeds the claimant's or taxpayer's tax liability for the tax year, the excess portion of the credit must be refunded.

If a claimant has no income tax liability for the tax year, the amount of the income tax credit will be equal to the remaining SBT credit amount the claimant could have claimed, had the SBT Act been in effect for the tax year. The Department of Treasury must prescribe the form for a claimant to use to claim an income tax credit.

MCL 125.2231-125.2263 (S.B. 834)
MCL 208.37e (S.B. 835)
MCL 206.270 (H.B. 5322)

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 nonprofit corporations that would oversee venture capital funds supported by private investment, the bills will help to foster economic development in Michigan, particularly in high-tech industries. Guaranteeing a rate of return or SBT credits to investors provides 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, will 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 will both benefit Michigan's economy and enhance the State's tax revenues.

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 will 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 should help to draw business development interests from outside the State.

Opposing Argument

Although the capital investment system created by Senate Bill 834 may benefit the State's economy in the long run, the legislation comes at a bad time. Since Michigan still is facing budget difficulties and must reduce and eliminate programs and/or raise revenue, the State cannot afford to offer an SBT credit to businesses that invest in the new Fund.

Response: The Fund will consist of investment from private interests, not State tax dollars. Also, while the private investment in the Fund at a negotiated rate of return should occur soon after the Fund's creation, investors may not claim an SBT credit until the

2009 tax year. In addition, if the Fund's investments realize the anticipated level of success, the tax credits will never have to be claimed. The credits will apply only if an investor does not receive its negotiated rate of return based on the Fund's performance. If Fund investments in venture capital companies are 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 the one in Senate Bill 834 and has not had to issue any tax credits to the initial investors. Even if the State has to issue tax credits between 2009 and 2020, the amount of those credits will constitute a debt of the Fund to the State, so any cost to the State in the form of tax credits eventually should be repaid, with interest, by the Fund. In the very long run, the balance of the Fund will revert to the State in 2054, so the system enacted by the bills should end up being a money-maker for the State. In fact, the Michigan Venture Capital Association has estimated that this legislation could result in the creation of over 6,000 new jobs and generate over $100 million for the State.

Opposing Argument

Providing 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 enacted by the bills, however, the State's taxpayers assume the risk, while private investors in the Fund retain the premium, through a guaranteed rate of return.

Opposing Argument

Although creating a Fund to invest in various venture capital companies might prove fruitful, there are some deficiencies in the bills. Since the Corporation will 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 includes the State Treasurer and the chief executive officer of the MEDC, they constitute a minority of the board's seven members. In addition, while the 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 may 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 require that tax credit certificates be issued when an investor's negotiated rate of return is 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 will be willing to invest in the Early Stage Venture Investment Fund, 2) the rate of return that will be guaranteed to individual investors, 3) the ultimate actual rate of return that will be realized by this Fund, or 4) the amount that investors will be eligible to claim as refundable credits against the single business tax or income tax, if the actual rate of return turns 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 may not exceed $30 million in any one year and $150 million during the life of the Fund, and investors may not claim these credits until 2009. While the bills 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 minimum potential direct cost of these bills on the State is zero, which will occur if the guaranteed rate return is actually realized. The maximum initial cost to the State will be $30 million in any given year and $150 million over the life of the Fund, and the earliest this initial cost may be incurred is FY 2009-10; however, over the longer term, the maximum potential cost to the State will probably be much less, or even zero, assuming the Fund eventually repays the State, with interest, for some or all of the credits paid to investors.

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