

SENATE STAFF ANALYSIS AND ECONOMIC IMPACT STATEMENT

(This document is based only on the provisions contained in the legislation as of the latest date listed below.)

Date: April 21, 1998 Revised: _____

Subject: Certified Capital Companies

	<u>Analyst</u>	<u>Staff Director</u>	<u>Reference</u>	<u>Action</u>
1.	<u>Johnson</u>	<u>Deffenbaugh</u>	<u>BI</u>	<u>Favorable/CS</u>
2.	<u>Beggs</u>	<u>Smith</u>	<u>WM</u>	<u>Favorable/CS</u>
3.	_____	_____	_____	_____
4.	_____	_____	_____	_____
5.	_____	_____	_____	_____

I. Summary:

Venture capital is typically the major source of funding for start-up companies. In recent years, there have been concerns regarding the availability of venture capital for such companies in Florida. This bill establishes a mechanism to provide financing, via certified capital companies, for start-up companies. Insurance companies are provided a premium tax credit to invest in certified capital companies which, in turn, will make investments in small, new or expanding businesses.

Private partnerships, corporations, trusts or limited partnerships may file for certification as a certified capital company (CAPCO) under the bill. CAPCOs certified by the Department of Banking and Finance could receive contributions of capital from insurers, which in turn would receive a credit against state premium taxes for each dollar contributed to a CAPCO, at the rate of 10 percent a year for 10 years, beginning with premium tax filings for the year 2000. To remain certified, CAPCOs would be required to meet investment benchmarks. At least 50 percent of CAPCO funds would have to be invested in businesses headquartered in and with their principal business operations in Florida ("qualified businesses") within 5 years of the CAPCO's certification date or risk decertification.

The Legislative Economic and Demographic Research Division estimates that the fiscal impact for CS/HB 1575, which is similar to CS/SB 1512, (assuming total credits available to all insurance companies is capped at \$50 million annually and \$500 million in total) for fiscal year 1998-99, will be -\$50 million in general revenue on a recurring basis, and cash impact of -\$75 million in 2001-02, -\$50 million for the following 8 years, and -\$25 million in 2010-11.

This bill creates section 288.99 and amends section 14.2015, Florida Statutes.

II. Present Situation:

Venture Capital

According to Coopers and Lybrand's report on *Economic Impact of Venture Capital Study*, "Venture capital is money provided by professionals who invest with management in young, rapidly expanding companies that have the potential to develop into significant contributors to the economy." The survey focused on young, venture capital funded, start-up companies. The survey noted that over 80 percent of the companies were technology based. The percentage of survey companies by industry were software (22%), biotechnology (20%), communications (14%), medical devices (14%), semiconductors and electronics (11%), other (10%), health care services (5%), and retail (4%). The survey also concluded that the jobs created by venture capital funded companies are typically high, quality skilled positions.

Florida companies are presently ranked fourth in the nation in total venture capital received, according to a recent article in the *Wall Street Journal*. Approximately \$400 million in venture capital was received in 1996. However, the article indicated that none of Florida's 18 venture-capital investments came from a Florida firm. Unlike publicly traded securities, venture capital investments are high-risk equity transactions that remain invested for several years. In order to encourage the formation and financing of new companies and the corresponding creation of jobs, economic and tax incentives are typically used. The venture capital industry is generally free of governmental regulation.

Louisiana (1983), Missouri (1996), and New York (1997) have enacted legislation to provide tax incentives for investments in certified capital companies. Significant capital has been raised in Louisiana and Missouri through programs similar to the type of certified capital program being proposed through legislation in Florida. While it is too early to assess the New York and Missouri programs, data is available on the Louisiana program. According to the State of Louisiana, Office of Financial Institutions, as of December 31, 1996, insurers had invested \$146.3 million in Louisiana CAPCOs, which show total certified capital of \$155.7 million. There have been \$184 million in tax credits generated and \$63 million actually used. Of the \$155.7 million invested in CAPCOs, Louisiana CAPCOs have made \$63.4 million in qualified investments. According to data generated and reported by CAPCOs, investments have been made in 62 qualified businesses, creating 2,809 jobs. Officials of the Office of Financial Institutions for the state of Louisiana indicate that the number of actual jobs created has not been verified.

Insurance Company Premium Tax

Pursuant to s. 624.509, F.S., insurance companies doing business in Florida are required to pay a tax on premiums written in the state in the preceding calendar year, equal to 1 percent of total annuity premiums, and 1.75 percent of premiums on all other lines of business in the state. Insurance companies are permitted to reduce their premium tax liability with a variety of tax credits which are provided for in statute. Police and firefighter's assessments are distributed by the Department of Management Services to local governments. Fire Marshal assessments, filing fees, and \$125,000 annually adjusted by the lesser of 20 percent of the growth in total retaliatory taxes are deposited in the Insurance Commissioner's Regulatory Trust Fund. The remainder of the

premium tax is deposited into the General Revenue Fund. For fiscal year 1997-1998, the general revenue proceeds of this tax are projected to total \$302 million.

Regulation of Insurance Company Investments

Part II of ch. 625, F.S., addresses the investment and lending activities in which insurance companies may engage using company assets. Section 625.302(1), F.S., specifies that insurers may invest or lend funds only in eligible investments. Pursuant to s. 625.303, F.S., new investments must be interest-bearing, must accrue dividends, must not be in default, and must be sold at or below market value in order to be eligible.

Section 625.304, F.S., restricts the authority of insurers to make any investment or loan, other than a policy loan or annuity contract loan of a life insurer, unless the same is authorized or approved by the insurer's board of directors or by a committee authorized by such board and charged with the supervision or making of such investment or loan. Section 625.305, F.S., requires that insurance company investments be diversified according to criteria in the law. Insurers' investments in stock are limited to 15 percent of assets. Investments in debt instruments are limited according to the grade of the investment, as determined by the Securities Valuation Office of the National Association of Insurance Commissioners (NAIC). For investments rated by the NAIC in the lowest grades (levels 5 or 6), insurers may invest only 1.5 percent of assets. Section 625.324, F.S., authorizes insurers to invest in the stock of corporations if the stock is listed and traded on a national securities exchange, or approved by the Department of Insurance.

III. Effect of Proposed Changes:

Section 1. Amends s. 14.2015, F.S., to authorize the Office of Tourism, Trade, and Economic Development (OTTED) to administer the CAPCO Act, enter into contracts in connection with the fulfillment of its duties, and promulgate rules in connection with the administration of the Act.

Section 2. Creates s. 288.99, F.S., to create the act to be known as the "Certified Capital Company Act." The purpose of this act is to provide an incentive for insurance companies to invest in certified companies, which investment will provide assistance in the formation of new businesses and expansion of existing businesses and creating new employment.

Definitions for terms used in the act are provided. Certified capital is defined to mean an investment of cash by a certified investor in a certified capital company which investment fully funds the purchase price of either or both its equity interest in the certified capital company or a qualified debt instrument issued by the certified capital company.

Certified capital company (CAPCO) is defined to mean a partnership, corporation, trust, or limited liability company that has as its primary business the investment of cash in qualified businesses and that is certified by the Department of Banking and Finance. Shares of equity interest or qualified debt instruments issued by the CAPCO must be issued to certified investors in a number of separate investment series.

Certified investor is defined to mean any insurance company that contributes certified capital.

Early stage technology business is defined as a qualified business that is involved, at the time of the certified capital company's initial investment, in activities related to developing initial product or service offerings. The term includes businesses less than 2 years old with annual revenues less than \$3 million.

Qualified business means a business that meets all of the following conditions: 1) The business is headquartered in Florida and its principal business operations are located in Florida; 2) At the time a CAPCO invests in the business, the investment is a small business, as defined in 13 C.F.R. s. 121.201, "Size Standards Used to Define Small Business Concerns"; and, 3) At the time the CAPCO makes its initial investment, the business being invested in must certify that it is unable to obtain conventional financing, meaning that it has been turned down by a commercial lender or cannot reasonably be expected to qualify for a commercial loan, that its business plan projects that the business is reasonably expected to achieve in excess of \$25 million in sales revenue in 5 years, that the business will maintain its headquarters in Florida for the next 10 years and any new manufacturing facility financed by a qualified investment will remain in the state for the next 10 years, and that the business has fewer than 200 employees at least 75% of which are in Florida.

A business predominantly engaged in retail sales, real estate development, insurance, banking, lending, oil and gas exploration or engaged in professional services provided by accountants, lawyers, or physicians does not constitute a qualified business.

Qualified distribution is defined to mean the following types of distribution or payment to equity holders of a CAPCO: 1) Costs and expenses of forming, syndicating, managing, and operating a CAPCO, including annual management fees in an amount that does not exceed 2.5 percent of the certified capital of the CAPCO, plus reasonable and necessary fees, including, but not limited to, legal and accounting fees, related to the formation and operation of the CAPCO; and 2) Any projected increase in federal or state taxes, including penalties and interest related to state and federal income taxes, of the equity owners of a CAPCO resulting from the earnings or other tax liability of the CAPCO to the extent that the increase is related to the ownership, management, or operation of a CAPCO.

Qualified investment is defined to mean the investment of cash by a CAPCO in a qualified business for the purchase of any debt, equity, or hybrid security of any nature and description whatsoever, including a debt instrument or security that has the characteristics of debt but that provides for conversion into equity or equity participation instruments, such as options or warrants.

Premium tax liability means any tax liability incurred by an authorized insurer under the provisions of s. 624.509, F.S. Premium tax credit allocation claims is defined to mean a claim for allocation of premium tax credits prepared and executed by a certified investor on a form provided by the department and filed by a CAPCO with the department.

Procedures for the certification of a CAPCO and grounds for denial or revocation are provided. In order to become certified, a person must file a verified, written application with the department, along with a nonrefundable fee of \$7,500 on or before September 1, 1998. An applicant is required to provide the following information: 1) The address of its principal office and each office in Florida; 2) The applicant's form and place of organization, and if the applicant is a corporation, a copy of its articles of incorporation and amendments to the articles of incorporation and bylaws, or if a partnership, a copy of the partnership agreement. 3) Documentation from the Department of State that the applicant is a legal entity or other commercial entity that is organized or otherwise registered and maintains an active status; and 4) The applicant's proposed business plan and financial condition and history, documenting net capital of not less than \$500,000 within 30 days prior to the filing of the application.

The department is authorized to deny any certification or revoke, restrict, or suspend any certification that has been granted if the department determines that the applicant or certificate holder, or any officer, director, or affiliated person of the applicant or certificate holder has: 1) Violated any provision of this section or any rule or order issued made under this section; 2) Made a material false statement in the application for certification; 3) Been adjudicated guilty of a fraudulent act in connection with the operation of a certified capital company; 4) Made a misrepresentation or false statement to, or concealed any essential or material fact from, any person with regard to a certified capital company; 5) Been the subject of any decision, finding, injunction, suspension, prohibition, revocation, denial or administrative order by a court of competent jurisdiction, federal or state securities law, rules, or regulation, or other entities listed.

The department is required to certify or refuse to certify an applicant as a CAPCO by December 31, 1998. If the department has not acted on the completed application within the time specified, the application is deemed approved. The department must approve the applicant if: 1) No evidence exists that the applicant has committed any act delineated in this section; and 2) At least two of the principles have at least 5 years' experience making venture capital investments and one principal/manager with such experience must be primarily located in a Florida-based office of the CAPCO. On or before December 31 of each year, each CAPCO is required to pay an annual, nonrefundable fee of \$5,000.

The department is authorized to enforce the requirements for CAPCOs. The department is authorized to adopt rules necessary to administer the provisions of this act.

The bill provides that decertification of a CAPCO will not impair the ability of a certified investor in such CAPCO to continue to claim future premium tax credits earned as a result of an investment in the CAPCO during the period in which it was duly certified. However, the bill further provides that decertification may cause the recapture of the premium tax credits previously claimed and the forfeiture of future premium tax credits to be claimed by investors. The bill authorizes the transfer of a certified investor's unused premium tax credits, if certain conditions are met.

The CAPCO is required to make qualified investments within a prescribed schedule over a period of five years. At least 20 percent of its certified capital must be invested in qualified investments by December 31, 2000, 30 percent by December 31, 2001, 40 percent by December 31, 2002, and at least 50 percent by December 31, 2003. At least 50 percent of such qualified investments must be invested in early stage technology businesses. Although unclear, it appears that this requirement applies as of December 31, 2003 and thereafter.

All capital not currently invested in qualified investments by the CAPCO must be held in financial institutions or held by a broker-dealer registered under s. 517.112, F.S., and invested in specified investments.

A CAPCO is prohibited from making a qualified investment in an amount greater than 15 percent of the total certified capital of the CAPCO at the time of investment.

Any certified investor who makes an investment of certified capital pursuant to an allocation of premium tax credits shall, in the year of investment, earn a vested credit against premium tax liability equal to 100 percent of the certified investor's investment of certified capital. A certified investor may take up to 10 percent of the vested premium tax credit per year, beginning with premium tax filings for calendar year 2000.

The credit to be applied against premium tax liability for any 1 year may not exceed the premium tax liability of the certified investor for that taxable year. A certified investor claiming a credit against premium tax liability earned through an investment in a CAPCO is not required to pay any additional retaliatory tax levied under s. 624.5091, F.S., as a result of claiming such credit.

The aggregate amount of capital for which premium tax credits shall be allowed for all certified investors under this section shall not exceed an amount that would entitle all investors to take aggregate credits of \$15 million annually or \$150 million in the total allocation. A CAPCO is required to file a premium tax allocation claim of at least \$15 million in order for an allocation to be made to certified investors. The bill provides a formula to allocate premium tax credits in the event an oversubscription occurs.

A CAPCO is authorized to make distributions to its equity holders, other than a qualified distribution, as defined, only if the CAPCO has invested an amount cumulatively equal to 100 percent of its certified capital in qualified investments. The minimum investment of funds received from Florida insurance companies in qualified investments is 50%. Thus, to reach the requirement of a cumulative amount of equal to 100% of total certified capital, up to half could come from investors other than Florida insurance companies. Payments to debt holders of the CAPCO are authorized without restriction with respect to repayments of principal and interest.

The bill requires that certain distributions from the CAPCO to the insurance companies and equity holders be audited, at the CAPCO's expense, by a nationally recognized accounting firm. The audit is to determine whether aggregate cumulative distributions from the CAPCO to all certified investors and equity holders, other than qualified distributions, have equaled the sum of the

CAPCO's original certified capital and any additional capital contributions. If a distribution exceeds in the aggregate the sum of the CAPCO's original certified capital and any additional capital contributions, the CAPCO is to pay the state 10 percent of the portion of the distribution in excess of the amount. Such payments cannot exceed the amount of tax credits used by the insurance companies.

The CAPCO is required to file an annual report with the OTTED. OTTED is required to report on an annual basis to the Governor, the President of the Senate, and the Speaker of the House of Representatives, on or before March 1 information relating to the investment activities of the CAPCOs.

The bill provides procedures and limitations for the allocation of credits. No allocation will be made to certified investors of a CAPCO unless such CAPCO has filed premium tax credit allocations claims in the aggregate amount of \$10 million.

The department is authorized to decertify a CAPCO if certain requirements are not met. The department is required to notify the CAPCO if it determines the CAPCO is not in compliance with the provisions of the act. The CAPCO may be subject to decertification in 120 days after the date of such notification unless the deficiencies are corrected.

All fees collected by the department pursuant to this act must be paid into the State Treasury and credited to the General Revenue Fund.

The Department of Revenue (DOR) is authorized to examine and audit the records of a CAPCO and certified investors to ascertain correctness and compliance of any report and financial return that has been filed. OTTED is authorized to adopt rules necessary to carry out its duties and responsibilities

Section 3. The Department of Banking and Finance is appropriated \$240,434 for fiscal year 1998-99 from the General Revenue Fund and four positions for the purpose of enforcing the provisions of the Act.

Section 4. OTTED is appropriated \$100,000 from the General Revenue Fund to implement the provisions of the act.

Section 5. Except as otherwise provided, the act shall take effect upon becoming a law.

IV. Constitutional Issues:

A. Municipality/County Mandates Restrictions:

None.

B. Public Records/Open Meetings Issues:

None.

C. Trust Funds Restrictions:

None.

V. Economic Impact and Fiscal Note:

A. Tax/Fee Issues:

The entities seeking certification would be subject to a \$7,500 application fee. Once certified by the department, certified capital companies would be subject to an annual fee of \$5,000. The number of entities seeking and ultimately receiving certification is indeterminate.

The bill is estimated to have the following impact on state revenues:

Issue/Fund	General Revenue		Trust		Local		Total	
	1st Year	Recurring	1st Year	Recurring	1st Year	Recurring	1st Year	Recurring
	\$	\$	\$	\$	\$	\$	\$	\$
1. Insurance Premium Tax Credits	0.0	(15.0)	*	*	0.0	0.0	0.0	(15.0)

* Insignificant

** Indeterminate

B. Private Sector Impact:

Businesses meeting the qualified business definition (meeting standard industry code, employee size and/or revenue criteria) would benefit from the availability of additional sources for funding operations. The availability of additional funding of start-up or expanding businesses would provide additional jobs in Florida.

The impact of the investment by CAPCOs on the Florida economy will depend on a large number of factors. The bill requires that only a minimum of half the funds received from Florida insurance companies be invested in qualified businesses. In similar programs in other states, a significant portion of the dollars generated as a direct result of the tax break has been invested in relatively safe investments such as government securities in order to offer additional security to the investing insurance companies. Also, operating costs of the CAPCOs will reduce the investments to some degree. Balanced against these “leakages” is the fact that the new investments, as the businesses grow and need additional capital, will tend to attract investments from sources other than the insurance companies.

Another important consideration is the proportion of the investment by the CAPCOs in companies that would not have received any funding, and therefore not existed, in the absence of the tax credit offered by this bill. This consideration addresses the issue of how efficient or inefficient current capital markets are in supplying funds to startup companies and the need for the government subsidy contained in this bill. To the extent that CAPCO investments displace other investors, there would be no new impact on the Florida economy. This consideration applies to both the direct investments of funds from Florida insurance companies and to capital coming into the state as the businesses grow. Also important are the growth rates that will be experienced by those businesses created as a result of the tax break incentives.

While ownership and most of the financial gains from the investments generated by the tax credits inure to the CAPCOs and their investors, the bill requires that a portion of earnings over a certain amount be returned to the state. If a distribution or payment to certified investors or equity holders exceeds in the aggregate the sum of the CAPCO's original certified capital and any additional capital contributions, the CAPCO is to pay the state 10 percent of the excess distributions.

The following table shows the results of REMI model runs projecting the economic impact on the state of the direct impact of the new uses of the tax reduction funds and the activities induced in the economy as a result of these uses. The model runs assume: 1) Total net new investment in qualified businesses equals \$500 million. This figure assumes that funds from insurance company investments used for securitization purposes and those used for operating costs are offset by new investments drawn to Florida from other sources so that total investment equals the amount of the tax break. 2) 30% percent of the qualified businesses which are invested in will fail, but those remaining will have growth in output of 45% the first year, 40% the second, 35% the third, tapering to more normal growth rates after 7 or 8 years. 3) A high and low range for the portion of CAPCO investments that will be in companies which would not have received funding except for this bill. The high range assumes that half of the companies invested in receive funding only as a result of this bill. The low range assumes that 30% of the companies receive funding only as a result of this bill. Please note that the fiscal years shown in the columns are for every other year.

	FY 98-99	FY 00-01	FY 02-03	FY 04-05	FY 06-07	FY 08-09
Types of impact:						
Net New Jobs	350 - 583	1,880 - 3,382	5,227 - 8,482	7,360 - 11,882	8,297 - 13,343	8,467 - 13,562
Change in Florida Personal Income (million of \$)	\$17.2 - 28.5	\$108.5 - 191.3	\$317.2 - 520.2	\$516.3 - 838.3	\$664.8 - 1,074.0	\$763.2 - 1,227.5

C. Government Sector Impact:

The bill requires CAPCO's, under certain circumstances, to make payments to the state of a portion of their distribution to insurance companies and equity holders. Such payments, if

due under the terms of the bill, would likely be a number of years in the future and of indeterminate amount.

According to estimates provided by the Department of Banking and Finance, the administration and the regulation of the certified capital company program would require the following funding on an annual basis:

1998-99	1999-00	2000-01
Expenses - Nonrecurring \$45,323 Recurring: 4 FTEs \$175,500	4 FTEs: \$175,500	4 FTEs: \$175,500

OTTED provided the following fiscal impact estimate for implementing the provisions of the bill in the first year:

\$50,000 Other Professional Services
\$ 7,500 Expenses for workshops and travel expenses
\$20,000 Database software development
\$85,000 Total first year costs

In subsequent years, depending on the number of companies receiving certification and the number of investors, OTTED's workload could be provided for by either other personnel services or a full-time employee with funding of no more than \$64,000.

The bill contains a fiscal year 1998-99 appropriation of \$100,000 from the General Revenue Fund for OTTED to implement this bill.

VI. Technical Deficiencies:

In calculating the potential distribution to the state if CAPCOs distributions exceed a certain amount, the bill compares distributions to certified investors and equity holders to the amount of original certified investments and any additional capital contributions. For the calculation to work, these references should be to the same investors. It is not clear that these are the same and the trigger for the state distribution might be more difficult to achieve.

VII. Related Issues:

As discussed in II. Present Situation, the Coopers and Lybrand survey indicated that 80 percent of the surveyed companies that were funded through venture capital were technology focused. The definition of qualified business in the bill does not provide such limitation or prioritization for funding those types of businesses that would provide higher paying positions.

VIII. Amendments:

None.

This Senate staff analysis does not reflect the intent or official position of the bill's sponsor or the Florida Senate.
