

**The Florida Senate**  
**PROFESSIONAL STAFF ANALYSIS AND ECONOMIC IMPACT STATEMENT**

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

Prepared By: Commerce Committee

BILL: CS/SB 1762

INTRODUCER: Commerce Committee and Senator Ring

SUBJECT: Capital Formation

DATE: March 28, 2007      REVISED: \_\_\_\_\_

	ANALYST	STAFF DIRECTOR	REFERENCE	ACTION
1.	Pugh	Cooper	CM	Fav/CS
2.			GO	
3.			FT	
4.			TA	
5.				
6.				

**I. Summary:**

CS/SB 1762 creates the Florida Capital Formation Act (the Act), which is designed to promote venture capital investment in Florida. The legislation reserves \$75 million in contingent tax credits to be used as guarantees for the private investments.

The CS creates the following entities to implement the venture capital program:

- The Florida Capital Investment Trust (the trust), a state beneficiary public trust to hold the contingent tax credits as collateral for investments made pursuant to this Act, and
- The Florida Opportunity Fund (the Fund), which will invest on a fund-of-funds basis, emphasizing investment in seed capital and early stage venture capital funds.

The trust may transfer and sell the tax credits to make up any shortfall in the guaranteed rates of return for the private investors who invest in the Fund. The transferred and sold tax credits can not be used before July 1, 2010, or after July 1, 2037. Tax credits may be used to reduce tax liabilities for sales and use tax, corporate income tax, insurance premium tax, and the tax on wet marine and transportation insurance.

CS/SB 1762 appropriates \$750,000 for FY 2007-2008 from the General Revenue Fund to the Florida Capital Investment Trust to finance startup activities.

It also directs the Office of Program Policy Analysis and Governmental Accountability (OPPAGA) to review specific aspects of the Capital Formation Act prior to the 2012 Regular Legislative Session and again in 2036, and submit reports as required to the Governor and legislative leaders.

CS/SB 1762 creates a new Part X in ch. 288, F.S., and amends ss. 213.053, 220.02, and 624.509, F.S.

## II. Present Situation:

### The Venture Capital Industry<sup>1</sup>

“Venture capital” is money provided by professionals who invest alongside management in young, rapidly growing companies that have the potential to develop into significant economic contributors. Venture capital is an important source of equity for startup companies.

Venture capital investments typically have several characteristics, including an investment in a start-up or expansion-oriented company that has a higher level of risk than is typically associated with traditional bank lending activities; equity participation in the business by the venture capitalist; long-term investments with a 5- to 10-year time horizon; and an established mechanism for the payout to the venture capitalist at the end of that time period.

Venture capitalists generally:

- Finance new and rapidly growing companies;
- Purchase equity securities;
- Assist in the development of new products or services;
- Add value to the company through active participation;
- Take higher risks with the expectation of higher rewards; and
- Have a long-term orientation.

Venture capitalists actively work with the company’s management by contributing their experience and business savvy gained from helping other companies with similar growth challenges. A venture capitalist may invest before there is a real product or company organized, known as “seed investing,” or may provide capital to a company in its first or second stages of development known as “early stage investing.” Venture capitalists mitigate their risks by developing a portfolio of young companies into a single venture fund.

Over the past decade, a number of states have adopted programs targeting the formal venture capital industry. Programs fall into five basic categories:

- Direct Investment by state agencies to individual businesses. This type of program may be problematic, because it is difficult to find state agency staff with appropriate expertise.
- Investment by state agencies or pension funds into privately managed funds that have extensive geographical limitations (such as enterprise zone location requirements).
- Investment by state agencies or pension funds into a portfolio of privately managed funds. Investments are made in several private partnerships along with other investors. This model is effective at diversifying risk and helping focus a variety of experienced investors on legitimate capital needs of businesses.

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<sup>1</sup> The primary source for information in this section is the National Venture Capital Association website, available at <http://www.nvca.org/def.html>. Last visited March 11, 2007.

- Private investment spurred by offering state tax credits for qualifying investments. Programs include: direct tax credits for investment in qualified businesses, and direct tax credits for investment in qualified venture capital funds.
- Private investment spurred by offering contingent state tax credits used as a source of value for guaranty of investment. The tax credits are contingent because they are not claimed unless the venture capital investment fails to meet a guaranteed rate of return.

#### Venture Capital in Florida

Enterprise Florida, Inc. (EFI) reports that in Florida, total venture capital spending was more than \$555 million for 114 deals in 2003 and 2004, and that 27 venture capital firms have headquarters in Florida.

EFI also reports that since the late 1990's, venture capital investment in Florida has fallen sharply, both in absolute dollar terms and as a share of the U.S. total. Despite being the fourth-most populous state, Florida ranked 13th in the U.S. in terms of venture capital investment in 2004. In 2004 Florida accounted for only \$300 million, or 1.42 percent of the total venture capital funding in the U.S.<sup>2</sup>

To date, Florida has promoted the investment of state funds in venture capital through two programs: the Cypress Equity Fund and the Certified Capital Company Act (CAPCO).

#### The Cypress Equity Fund

In 1995, the Enterprise Florida Capital Partnership, Inc., created the Cypress Equity Fund as part of a strategy to help improve Florida businesses' access to venture capital. The Cypress Equity Fund's purpose is to facilitate initial venture capital investments by Florida private financial institutions and other investors, and provide a means to encourage national venture capital managers to consider investment opportunities in Florida. This program invests both public and private funds into privately managed venture capital funds.

The Cypress Equity Fund is designed as a "fund of funds" to invest in national private venture capital funds that, in turn, would invest in companies with high growth potential. However, investments may be made in venture capital funds located anywhere in the country and therefore are not required to target in-state companies.

The Cypress Equity Fund began with a total of \$35.5 million in commitments: \$20.5 million from five private financial institutions, and \$15 million from the Florida State Board of Administration. The Cypress Equity Fund Management Corporation, an entity established by the Capital Development Board, is responsible for overall management of the fund. The corporation, in turn, contracts with a private equity manager to invest fund assets with national venture capital firms.

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<sup>2</sup> "Florida Early Stage Venture Capital Proposal." Prepared by Enterprise Florida, Inc. in 2006 and updated March 9, 2007. Page 6.

In a 1998 report on the Cypress Equity Fund, OPPAGA concluded that the fund has not contributed to achieving the goal of improving Florida businesses' access to venture capital, because its investments were not targeted to in-state companies.<sup>3</sup>

As of Dec. 31, 2006, the Cypress Equity Fund portfolio is valued at \$10.3 million. Since the program's inception, distributions and realized gains to investors have totaled \$49.5, and the net compound internal rate of return is 22.5 percent.<sup>4</sup>

### CAPCO

In 1998, the Florida Legislature enacted the Certified Capital Company Act. This program encourages private investment in venture capital by providing direct tax credits for investment in qualified businesses. The stated purpose of this act is to stimulate a substantial increase in venture capital investments in Florida by providing an incentive for insurance companies to invest in state-certified capital companies (CAPCOs) which, in turn, will invest in new or expanding businesses. Eligible insurance companies are granted insurance premium tax credits in amounts equal to investments in CAPCOs. The increase in investment capital is intended to contribute to employment growth, create high-paying jobs, and expand or diversify Florida's economy.

A 2005 review of the CAPCO program by the Governor's Office of Tourism, Trade, and Economic Development (OTTED) indicated that \$3 million was invested in 12 new investee companies, ranging from a business that specializes in transportation of construction materials, to child-care centers, to pool and spa installation.<sup>5</sup> Another \$1.8 million was invested in existing companies. As of December 31, 2005, a total of \$153.4 million has been made available to the 59 investee companies, which have created 1,028 jobs.

While as many as nine states have created CAPCOs, this type of program is increasingly viewed as the more "problematic" of the Venture Capital Funds (VCF) programs, in terms of:

“...its high cost, poor design and target inefficiency. Unlike any other VCF program, the CAPCO program provides a 100% premium tax credit to insurance company investors. In effect, the government underwrites the entire investment risk.”<sup>6</sup>

### **III. Effect of Proposed Changes:**

CS/SB 1762 creates the Florida Capital Formation Act and two entities to implement its provisions. It reserves \$75 million in contingent, transferable tax credits that will serve as the

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<sup>3</sup> “Review of The Enterprise Florida, Inc. Capital Development Board's Cypress Equity Fund,” Report No. 98-33. Available at <http://www.oppaga.state.fl.us/monitor/reports/pdf/9832rpt.pdf>

<sup>4</sup> Letter from Abbott Capital to Enterprise Florida, Inc., dated Feb. 15, 2007. On file with the Commerce Committee.

<sup>5</sup> “Certified Capital Company Act” (CAPCO) Annual Report, January 1-December 30, 2005. Prepared by OTTED. Copy on file with the Commerce Committee

<sup>6</sup> Daniel Sandler, Professor at the Faculty of Law, The University of Western Ontario, London; senior research fellow of the Taxation Law and Policy Research Institute, Melbourne; and associated with Minden Gross Grafstein & Greenstein LLP, Toronto. See Daniel Sandler, *Venture Capital and Tax Incentives: A Comparative Study of Canada and the United States* (Toronto: Canadian Tax Foundation, 2004) (“Sandler VC Study”).

state's investment share in venture capital projects. These credits can not be exercised before July 1, 2010, or after July 1, 2037.

**Section 1** redesignates Parts X and XI of ch. 288, F.S., and creates a new Part X devoted to the Florida Capital Formation Act. The relevant sections of law created are ss. 288.9621-288.9628, F.S. It also defines a number of terms used in the new Part X.

CS/SB 1762 creates two financial entities to implement the Act, and delineates their responsibilities.

#### The Florida Capital Investment Trust

The trust is created as a state beneficiary public trust to hold the \$75 million in contingent tax credits as a guarantee for investments made under the Act. The tax credits may be used to reduce tax liabilities for sales and use tax, corporate income tax, insurance premium tax, and the tax on wet marine and transportation insurance. The tax credits may be used from July 1, 2010, to July 1, 2037. The tax credits may not be used to offset any local-government tax liabilities.

The trust will be governed by a Board of Trustees: five voting members and two nonvoting, ex officio members. The Governor will appoint three of the voting members, and the President of the Senate and the Speaker of the House of Representatives will appoint one voting member each. Terms of the initial members shall be staggered, as explained in the bill, but subsequent voting members shall be appointed to 3-year terms. The two nonvoting, ex officio members shall be designees of Enterprise Florida, Inc. (EFI), and the Florida Research Consortium.

CS/SB 1762 specifies criteria for: filling board vacancies; the trustees' eligibility for travel and per diem expenses pursuant to s. 112.061, F.S.; avoiding conflicts of interest; and other administrative matters. Trustees shall be selected based on their demonstrated expertise and competence in supervising early stage investment managers, the fiduciary management of funds, the administration and management of a publicly listed company, or experience and competence in public accounting, auditing, and fiduciary responsibilities.

Among the powers and duties of the Board of Trustees are:

- Receive, hold, transfer, and sell state tax credits;
- Develop, with the assistance of the state Department of Revenue (DOR), a system to register tax credits received by the trust and later transferred;
- Create a system of documentation to verify tax-credit claims by persons who receive the credits pursuant to this program and whether they were taken in the correct fiscal year;
- Hire knowledgeable employees; and
- Charge fees for its guarantees to investors or for other services, to ensure that the trustees' operations may be conducted without subsequent legislative appropriations.

#### Issuance and Use of the Tax Credits

As mentioned earlier, the trust shall receive a total of \$75 million in contingent, transferable state tax credits that may be used to reduce a person's or entity's tax liability imposed by ch. 212, F.S. (sales and use tax), ch. 220, F.S. (corporate income tax), s. 624.509, F.S. (insurance premium tax), and s. 624.510, F.S. (tax on wet marine and transportation insurance).

The tax credits are only to be transferred and sold by the trust for the purpose of fulfilling its certificate obligation (or investment contract) to investors. Basically, the credits are treated as collateral for the private investments into the Florida Opportunity Fund:

- If the investment meets or exceeds its rate of return, as guaranteed in the certificates entered into by the Trust and investors, the credits are not sold.
- In the event that the investment falls short of the guaranteed rate of return, then the Trust would sell the credits to make up the difference.<sup>7</sup> The credits must be sold through competitive bid unless the sale is for the full face value of the credits.
- The trust also would transfer the sold credits to the purchaser, who could use them against certain state tax liabilities, as specified in CS/SB 1762. These transferred tax credits shall not be exercised before July 1, 2010, or after July 1, 2037.

The Board of Trustees must notify the Governor, the President of the Senate, and the Speaker of the House of Representatives immediately in writing when credits are transferred. If the credits are subsequently transferred to an entity other than the Board of Trustees, then the Board of Trustees must be immediately notified in writing, and in turn shall notify DOR.

The tax credits shall be transferred in increments of at least \$100,000, and no more than \$20 million worth of transferred credits may be claimed in any single state fiscal year. A copy of the document transferring a tax credit shall be forwarded to DOR's executive director, who shall allow the credit to be claimed against tax liabilities owed by a person or business, consistent with the terms of the transfer document.

If the credits do not exhaust the purchaser's tax liability, the balance of the credit may be refunded by the state. If the credit is not claimed in the year in which it was designated, the taxpayer may file an amended claim to take advantage of the credit. Taxpayers receiving these tax credits must maintain appropriate documentation until the time for conducting an audit has passed.

DOR, in conjunction with the Trust's Board of Trustees, may adopt rules governing the manner and form of the documentation required to claim credits that have either been granted or transferred.

#### The Florida Opportunity Fund

CS/SB 1762 creates the Fund as the vehicle for investing in a "fund-of-funds" model, emphasizing investment in seed capital and early stage venture capital funds focusing on opportunities in Florida.

At the request of the trust, EFI will establish the Fund as a limited liability company with a board of directors. EFI's vice chairperson shall pick a five-person appointment committee from among EFI's board of directors, and the appointment committee shall select the five initial members of the Fund's board of directors. The Fund's board of directors must include persons who have

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<sup>7</sup> According to EFI, seven states (Arkansas, Iowa, Michigan, Ohio, Oklahoma, South Carolina, and Utah), have instituted a contingent tax credit venture capital program. There is no record to date of a state having to sell its contingent tax credits to make up a shortfall in guaranteed investment earnings.

expertise in selecting and supervising early stage investment managers, in fiduciary management of invested funds, or in other areas considered appropriate by the appointment committee. The Fund's board members are subject to restrictions on conflicts of interest, as expressed in the Fund's organizational documents, and may not have an interest in any venture capital investment or other investment selected by the corporation.

Among the Fund's responsibilities is to select an early stage venture capital investment fund allocation manager who will make the actual investments.

The Fund is not precluded from investing in funds "with a wider geographic spread of portfolio investment." However, it shall require these investment funds to have either a record of successful investment in Florida, be based in Florida, or have an office in Florida.

The Fund also may invest in new venture capital funds if they are administered by experienced and proven investment managers, as long as those venture capital funds invest in Florida companies. Eligible Florida-based companies shall include, but are not limited to, enterprises in the life sciences, information technology, advanced manufacturing processes, aviation and aerospace, and homeland security and defense.

Specific criteria include:

- The Fund's investments may not be direct investments with individual businesses, but must consist of partnership interests in private venture capital funds (the "fund-of-funds" approach).
- Investments must have received capital from other sources in an amount at least equal to what the Fund has invested.
- The Fund may negotiate contract provisions with receiving venture capital funds regarding a "draw back" of management fees, as well as other provisions to maximize investment in seed and early stage Florida companies.

CS/SB 1762 also specifies that state-chartered banks and domestic insurance companies are permitted to invest in the Fund.

If the Fund is liquidated or has returned all capital to designated investors by agreement, or if the guarantee capacity of the fund is determined by its board to be sufficient for additional certificates, then a new funding may be implemented for future investments. If the Fund's board takes exception to an additional funding, this additional funding may be implemented only without the benefit of certificates from the board.

#### Annual Reporting Requirements

The trust's board must submit an annual report on its activities to the Governor, the President of the Senate, and the Speaker of the House of Representatives. The report must include the following:

- A copy of the independent audit of the Opportunity Fund;
- A valuation of the assets of the Opportunity Fund;

- A review of the progress of the fund allocation manager in implementing the Opportunity Fund's investment plan;
- The benefits of the state resulting from this program, including the number of businesses created and their associated industry;
- The amount of capital attracted to Florida; and
- Any sale and transfer of tax certificates without identifying the transferees or amounts paid by each; and any sale of tax certificates reasonably anticipated by the board to meet its certificate obligations.

**Section 2** amends s. 213.053, F.S., to give DOR permission to disclose to the trust confidential information pertaining to tax credits claimed under the new Part X of ch. 288, F.S.

**Section 3** amends s. 220.02, F.S., to add the corporate income tax credits awarded under this Act at the end of the list of similar credits.

**Section 4** amends s. 624.509, F.S., to include tax credits created in this Act in a list of credits and deductions against the premium tax.

**Section 5** appropriates in FY 2007-2008 the sum of \$750,000 from the General Revenue Fund to the trust to be used for startup activities to implement its responsibilities.

**Section 6** directs OPPAGA to conduct an interim review and evaluation of the Capital Formation Act's "effectiveness and viability." The review/evaluation is to be done prior to the 2012 Regular Legislative Session. OPPAGA is directed to specifically evaluate the following matters:

- the total capital investment in the state;
- the private-sector investment;
- the rate of return;
- the creation of new businesses and jobs;
- the debt incurred; and
- industries affected.

OPPAGA also is directed to recommend outcome measures for further evaluation of the program.

OPPAGA is directed to submit a report of its findings and recommendations to the Governor, the President of the Senate, and the Speaker of the House of Representatives by January 1, 2012.

In 2036, OPPAGA shall conduct a final review of the program in accordance to this section, and submit a final, written report to the Governor, the President of the Senate, and the Speaker of the House of Representatives by January 1, 2037.

**Section 7** provides an effective date of July 1, 2007.



**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:**

CS/SB 1762 reserves \$75 million in contingent, transferable state tax credits for use by the Trust to attract private venture capital investment. The credits can not be claimed until the tax year that begins July 1, 2010.

The Revenue Estimating Conference determined by consensus that there would not be an immediate, negative cash impact to the state, but agreed there would eventually be a recurring negative impact when the credits begin to be claimed. The conferees used a figure of a negative \$15 million as a non-recurring fiscal impact to the state, capped at a negative \$75 million.

**B. Private Sector Impact:**

None.

**C. Government Sector Impact:**

DOR may incur some costs related to rulemaking and in assisting the trust's board in developing a system of registering the tax credits for easy tracking.

**VI. Technical Deficiencies:**

None.

**VII. Related Issues:**

None.



## **VIII. Summary of Amendments:**

None.

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This Senate Professional Staff Analysis does not reflect the intent or official position of the bill's introducer or the Florida Senate.

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