

Approved 04/06/87
Date

MINUTES OF THE House COMMITTEE ON Economic Development

The meeting was called to order by Jayne Aylward at
Vice-Chairperson

3:30 a.m./p.m. on Monday, March 23, 1987 in room 423S of the Capitol.

All members were present except: Representatives Barkis, Hoy, Kline, RH Miller,
Foster, Goossen, Moomaw and Teagarden (All Excused)

Committee staff present:
Jim Wilson, Revisor
Tom Severn, Research
Lynn Holt, Research
Molly Mulloy, Secretary

Conferees appearing before the committee:

Mark Burghart, Department of Revenue
Dave Barclay, Department of Commerce

Vice Chairman Jayne Aylward called the meeting to order and opened the hearing on S.B. 68 and S.B. 69. She introduced Tom Severn and asked that he brief the committee on both bills.

Mr. Severn distributed copies of corrected Supplemental Notes on both bills (Attachment 1) as amended by the Senate Committee on Assessment and Taxation. He noted that most of the changes in S.B. 68 involve changing terminology and clarifying that expenditures (not just investments) qualify for the credit. He said that research and development expenditures are defined by the new federal IRS code. He explained that there is a change in the bill regarding income tax credits, adding that taking tax credits was very complicated in the original legislation with both carrybacks and carryforwards. Now the investor can take 25% of his credit up to the extent of his tax liability and can carry the balance forward for an unlimited number of years until the entire amount is dissolved. However, carrybacks were eliminated in the amended bill. Mr. Severn said the amended bill has desirable changes for both the investor and for the Kansas taxpayers. In discussing S.B. 69, Mr. Severn said that seed capital is the riskiest kind of venture capital and could consist of just a couple of people with a great idea working in a garage. He said that if public funds were invested in a seed capital pool, they would have a senior position to private funds but would also have a lower rate of return.

Mark Burghart, Department of Revenue, testified that although his department takes no position on the merits of either bill, they support the amendatory language in both bills in regard to the carryback feature (see Attachment 2). After answering questions from committee members, Mr. Burghart was asked by Rep. Leach to look into the possibility of credits from failing companies being transferred over to the businesses that purchase them.

David Barclay, Department of Commerce, spoke in support of S.B. 68 and 69. He stated that his department certifies and registers venture capital companies in Kansas and would be involved in the same process with seed capital pools if the bills were passed. He added that the amendments to S.B. 68 simplify enormously the computing of tax credits and make it conform to other tax bills.

Mr. Barclay explained the difference between seed capital companies and venture capital companies by stating that there are four stages in venture company development: 1) prestart 2) prototype development 3) commercialization and 4) expansion. He said that seed capital investments occur during the first two stages. Characteristics of the pre-start stage are 1) the company is not yet in operation 2) the prototype is just in blueprint form 3) the company is at least two years from the break even point 4) they need seed capital to build the prototype and 5) management usually consists of just the inventor. In the second stage (prototype development), characteristics are 1) the prototype is built but not yet in operation 2) less than two years from the break even point remain and 3) money is needed to build the prototype and to build the productive capacity of the company.

Unless specifically noted, the individual remarks recorded herein have not been transcribed verbatim. Individual remarks as reported herein have not been submitted to the individuals appearing before the committee for editing or corrections.

CONTINUATION SHEET

MINUTES OF THE House COMMITTEE ON Economic Development,
room 423S, Statehouse, at 3:30 a.m./p.m. on Monday, March 23, 1987.

Mr. Barclay said a 1986 survey of venture capital companies in the U.S. found the key to success for seed capital funds is to diversify their investments among at least 15 different companies in order to protect their investment. For example, a company could put \$10,000 in 15 different groups for a total of \$150,000 and keep the \$50,000 remaining for followup financing and reserve. He added that this reserve is important so that if at a later stage a seed capital company needs additional working capital, money is available for that purpose. He added that in the 1986 study mentioned earlier, 45% of the venture investments in seed capital were in followup financing, so this is a large component. He urged the committee to keep the floor for private funds at \$200,000.

Mr. Barclay next summarized the decertification process for seed capital companies, saying they paralleled those for venture capital activities.

After additional questioning of the conferees by committee members, Vice Chairman Aylward asked Mr. Barclay to prepare a short synopsis for the committee which would show the difference between seed capital and venture capital companies.

The hearing concluded at 4:45pm. The next meeting is scheduled for Tuesday, March 24.

(1)

CORRECTED
SESSION OF 1987

SUPPLEMENTAL NOTE ON SENATE BILL NO. 68

As Amended by Senate Committee on
Assessment and Taxation

Brief of Bill*

S.B. 68, as amended, would allow research and development activity credits of $6\frac{1}{2}$ percent of amounts expended for such activities rather than "invested for" such activities. This change would permit limited partners in a research venture to take the credit only when expenditures are made, and would permit such partners to dispose of their interests before all of the funds invested are expended. The acquiring party would then take the remaining part of the credit when the remaining funds were invested. *expended.*

Another change is that the credit, if it cannot be taken because it exceeds the tax liability, may be carried forward and taken in any succeeding year. The credit and any amounts carried forward would no longer be limited to 25 percent of the tax liability. However, credits could no longer be carried back to previous years.

Finally, allowable expenditures are defined by reference to the recodified federal Internal Revenue Code of 1986.

* Bill briefs are prepared by the Legislative Research Department and do not express legislative intent.

Background

This legislation was initially recommended by the Task Force on Capital Markets and Taxation of the Legislative Commission on Economic Development.

The Senate Committee amended the bill at the suggestion of the Department of Revenue to simplify administration of the credit.

SESSION OF 1987

SUPPLEMENTAL NOTE ON SENATE BILL NO. 69

As Amended by Senate Committee on
Assessment and Taxation

Brief of Bill*

S.B. 69, as amended, relates to the income tax credits for investment in certified venture capital companies by allowing such credits for investments in certified local seed capital pools and by changing the way that the credits may be claimed. First, would allow an income tax credit of 25 percent of a cash investment in a certified local seed capital pool which has a minimum private cash investment of \$200,000. Public funds may be, but need not be, invested in the pool, and if such funds were invested, they would have a senior position to, but would have a lower rate of return than, the private investments.

The Secretary of Commerce would be required to issue rules and regulations for making an application for certification of a local seed capital pool and to specify the information that must be submitted at the time of application. To qualify, the pool would specify the level of capitalization that the company expects, and to show that the purpose of the pool is to encourage and assist in the creation of Kansas businesses and to provide maximum opportunities for the employment of Kansans by making seed capital available to Kansas businesses.

The Senate Committee also conformed the bill to the credit provisions of S.B. 68.

* Bill briefs are prepared by the Legislative Research Department and do not express legislative intent.

Background

This legislation initially was recommended by the Task Force on Capital Markets and Taxation of the Legislative Commission on Economic Development.

The bill was supported by the Chairman of the Reno County Chamber of Commerce.



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KANSAS DEPARTMENT OF REVENUE
Office of the Secretary
State Office Building · Topeka, Kansas 66612-1588

M E M O R A N D U M

To: The Honorable Phil Kline, Chairman
House Committee on Economic Development

From: Harley T. Duncan, Secretary
Department of Revenue

Re: Senate Bills No. 68 and 69

Date: March 23, 1987

The Department of Revenue takes no position on the merits of either Senate Bill No. 68 (Income Tax Credit for Research and Development) or Senate Bill No. 69 (Income Tax Credit for Investment in Local Seed Capital Pools). However, both bills do contain amendatory language which was proposed by the Department and adopted by the Senate Committee on Assessment and Taxation in order to eliminate a great deal of taxpayer confusion regarding the computation of the credits.

The original bills contained a rather unique carryback feature. They provided that taxpayers could carryback three years the amount by which 25% of the tax credit exceeded 25% of the taxpayer's tax liability. Any unused credit could then be carried forward. Although the carryback provisions could be managed for a one year filing, significant problems would arise if there were qualifying investments made over a period of years. In some instances, it would be possible to have carrybacks and carryforwards reported in the same tax year. It would be very difficult for taxpayers and the Department to identify the investment made in a particular year and also determine the appropriate amount of the credit to be claimed. This problem would be exacerbated by the fact that the income of the taxpayer claiming the credits could be adjusted years after the fact as a result of federal audit adjustments. These federal adjustments would force a recomputation of the credits claimed in each year.

In our view, and in the opinion of most taxpayers with whom we have communicated, such a level of complexity was never envisioned and certainly never intended by the Legislature. It is possible that the carryback scheme actually served as a disincentive to investors. The added complexity creates the need for costly professional preparers which in turn reduces the overall economic benefit provided by the legislation.

To simplify matters, we proposed that the carryback format be eliminated. In its place, we proposed that taxpayers be allowed to offset 25% of the total credit plus any applicable carryforward against 100% of the tax liability in any one tax year. This methodology would not detract from the overall economic benefit derived by the taxpayer claiming the credits.

We would request that the amendatory language in both bills dealing with the carryback feature be retained.