EXHIBIT 18
DATE 4.11.05 April 5, 2005
SB 511

An Act Exempting Equity Investments in Early Stage Growth Companies from Capital Gains Tax.

SB 511 Sen. Jeff Mangan, sponsor Short Title: "Allow deduction of stock capital gains from qualified start-up corporations"

Purpose: to provide an incentive that will spur increased equity investment in Montana business—specifically, in early stage, productive companies with large potential markets, and large potential for increasing incomes and employment.

The bill allows a tax deduction for capital gains earned from sale of stock in privately-held, small Montana corporations that actively produce goods and services, are organized and aimed for large-scale growth, and attract equity investors on that basis.

BENEFITS: why should we do this?

(1) **Actual early-stage investment funds** tell us this is the one thing we could do that would most help them raise money for Montana companies.

(2) **Equity investment in growth companies drives high-wage job creation.** As a low-population rural area, we don't get our share.

- ♦ **Montana had $68 million** of early-stage investment, 1994-2003.
  It should have been $660 million, for our share of the US economy.

(3) **The economic gains are large; costs are small.** Investors we've spoken to believe that **$60 million of new investment** would occur in the first 3 years. At $55,000 per job, that's 1,000 new jobs created, at zero cost in revenues (since investments must be held 3 years to qualify.)

- ♦ By the time the deduction starts kicking in, new taxes from income, employment and property tax will exceed the "cost" of capital gains tax not collected.

(4) **It's easy to administer**—Dept. of Revenue vets the tax returns, as they always do. No new programs, boards or committees. Any added staffing would be within the existing DOR, at minor cost.

(5) **This incentive rewards economic performance AFTER it has occurred.**

- ♦ The big problem with past incentive programs—such as the Capital Companies ("CapCo") Act—is that credits are given and costs incurred before the desired results (job and income growth) are achieved. Administrative boards, added staff, oversight, penalties and litigation are required to assure results.
- ♦ But capital gains only happen if the subject companies have already multiplied in value—which means they've already produced new jobs, incomes (and state tax revenue). Only then is an incentive due, in the form of foregone capital gains tax.
- ♦ In many cases, the "foregone" capital gains revenue will be from investments that in fact would never have happened in the first place, without this incentive.

LIMITS and PROTECTIONS

The deduction would specifically exclude large companies (over 100 employees) and corporations that are already publicly-traded. ♦ It also excludes passive or trading kinds of investments, corporate vehicles created to hold non-Montana assets, or other "shell companies." ♦ Capital gains from real estate sales, sales of futures contracts and other types of passive investments would NOT be exempt from taxation under this bill. ♦ Investors cannot "roll over" stock from other types of corporations into qualified stock, without paying taxes. Hence, only a very small current revenue stream—**less than $50,000 per year**—is affected.

Even this small revenue impact is deferred, because the deduction would be limited to investments made after December 31, 2004. The holding period for business investment of this type is usually 3 years and up*, and a 3 year holding period is required in the bill. Thus, there will be **zero impact** on the current revenue stream of capital gains taxes, until the 4th, 5th and later years after enactment.

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Bill #: SB 511 Sponsor: Sen. Jeff Mangan

"Allow deduction of stock capital gains from qualified start-up corporations"

FACT SHEET:

Economic Justification for Targeted Capital Gains Deduction

60% to 80% of all net new jobs are produced by small companies.[1] Within that category, the vast majority of job and income growth is due to a surprisingly limited group. Just 4% to 8% of small firms are "rapid growth companies," producing over 70% of all net new jobs in the small-company sector.[2]

Such companies are organized and aimed for large-scale growth (for example, are organized as C-corporations); are capable of attracting and do attract outside equity investment (early-stage "angel investment" or "seed capital"); and typically sell products or services into large national and international markets. Investments in such small companies in an early stage of formation and growth are extraordinarily beneficial to the state in terms of job and income generation, if they are successful. The realization of capital gains from sale of stock in a small company that was privately-held when the investment was made *indicates that such an investment has indeed been successful, has delivered employment and income benefits to the state, and therefore merits the incentive and the reward of exemption from gains taxation.*

But shouldn't market forces yield the right level of investment, without government intervention? Not for states like Montana. Our small population, distance from large urban and industrial centers, and the relatively few business investment opportunities available here, combine to make the per-unit investigation and underwriting costs of such early stage investment very high, compared to urban areas. This results in what is defined in economics as a market failure: because one of the preconditions of a free market (equal and low-cost access to information) is not being met, the market does not function as it should, and does not yield optimum results. *In concrete terms, that means that good, well-qualified business ventures in Montana are not receiving the review they should get from knowledgeable investors, and that economically sound, job-creating investments are not being funded.*

Solid evidence supports this theoretical conclusion. Typically, non-metro counties across the U.S. are home to about 17% of all businesses, but receive only 0.8% of all venture capital investment—less than 1/20th their proportional share.[3] Venture capital placements in Montana over the last 10 years, including our 2 metropolitan counties, were about 10% of the amount that would be expected, based on Montana's share of gross state product.[4] **Over the 10 years 1994-2003, Montana had $68 million in venture investment; for our share of the US economy, it should have been $660 million.**[5] During economic downturns, the situation is far worse. In 2003, for example, $18.1 billion of venture capital was placed in the US versus $300,000 in Montana, that being about **1/130th of an even share.**

This market failure requires and justifies a government intervention in the form of the tax deduction proposed in SB 511

NOTES

[1] US Small Business Administration Office of Advocacy, "Small Business by the Numbers," June 2004, at http://www.sba.gov/advo .

[2] "Tax Incentives and Informal Venture Capital: of Love and Angels," Daniel Sandler, July 15, 2004, in Net News; http://www.nasvf.org/web/all press.nsf/pages/9255; accessed at www.matr.net/print-11506.html

[3] Brian Schmit, "Assessing the Availability of Traditional Venture Capital in the US: A Preliminary Analysis," NY, The Community Development Venture Capital Alliance, Dec. 2002, pp. 2-4.

[4] US Bureau of Economic Analysis. Montana's share of US total Gross State Product was 0.22% (about 1/5 of 1%) in 2003. This figure is relatively stable from year to year.

[5] Montana venture capital disbursements, 1994-2003: "Opportunity for a Montana In-State Private Equity Program," Credit Suisse First Boston Private Equity, July 2004.
US venture capital disbursements, 1994-2003: US Small Business Administration, *The Small Business Economy: A Report to the President*, Washington DC, 2004, p. 32 (citing compiled data from *Venture Capital Journal* and *National Venture Capital Association Yearbook 2003*, by Venture Economics.)
From the above sources, total venture capital disbursements for 1994-2003 in the US were $299.8 billion. Montana's proportional share, at 0.22%: $659,560,000. Actual Montana disbursements, 1994-2003: $68,400,000 = 10.4% of proportional.

IMPACT CALCULATIONS – Capital Gains Deduction for Stock of Qualified Corporations

A. Negative impact.

1. Revenues from qualified companies.

Total MT capital gains income in 2003 was about $791 million, of which, according to the Revenue Department's most recent study, about 27.25% would have been from sales of corporate securities, indicating $215.5 million of income that could potentially be exempted.[1] The proposed exemption is limited to securities of small corporations, which, according to a recent study sponsored by the SBA, account for 27.9% of total corporate market value[2], which reduces potentially exempted income to $59.9 million. (*Note: SBA figures use 500 employees as the cutoff for a "small" company, where the proposed exemption specifies 100 employees. Clearly, the proportion of market value represented by securities of under-100 companies will be much smaller than for under-500 companies, but no estimate of such value is readily available.)*

Further, the deduction is limited to privately-held small corporations: those whose stock was not publicly-traded when the investment is made. Figures for total market value of privately-held companies are not directly available, but can be reasonably estimated by subtracting total value of traded securities (the Wilshire 5000 index stocks) from the total of all equity issues at market value, taken from the Federal Reserve Flow of Funds tables.[3] By that measure, privately-held securities total $2.4 trillion of $15.6 trillion, or 15.4% of total market value. This reduces potentially exempted income to $9.22 million ($59.9 X 15.4% = $9.22).

The bill also excludes passive investment entities (in broad terms, the entire finance, insurance and real estate, or FIRE, sector) from the exemption. Smith Barney Citigroup reports that the relative capitalization of the FIRE sector, as reflected in weighting of the S&P 500 index, is 20.3%,[4] leaving 79.7% X $9.22 million = **$7.35 million as potentially exempted income.**

This qualified income stream of $7.35 million (from capital gains due to sales of corporate stock of small, non-public, non-passive companies both inside and outside Montana), multiplied by the current net capital gains rate of 5.9%, yields a **potentially-affected tax revenue stream of $433,522 per year from capital gains on sales of stock of qualified companies domiciled both inside and outside the state.**

2. Revenue from qualified Montana-domiciled companies.

However, a final reduction is proposed in the bill, restricting qualified securities to those of only Montana companies which meet all the other targeting restrictions above. What part of reported capital gains income in Montana derives from sales of stock in qualified Montana corporations?

Montana produces about 0.2% (1/5 of 1%) of national GDP.[5] Considering that Montanans are much more likely than out-of-state investors to be informed about, and therefore to hold, equities in privately-held Montana firms, and also considering that many Montanans earn share ownership in their employing companies, a large proportion of which will be Montana firms, the proportion of Montana corporate securities in the total portfolio of Montana investors probably is a multiple of the pro-rata share of Montana company value in total US company value. If Montanans hold 10 times a proportional share, [6] that would be 2% of their portfolios. We will assume, then, that 2% of the total capital gains realized from stocks held by Montana-domiciled taxpayers derive from securities of Montana-domiciled corporations.

To assure that there is no underestimate, we must also take account of the fact that Montana has an uncommonly high proportion of small companies. We will make that adjustment by assuming that all non-public companies in Montana are small (and in fact, there only about 10 companies in Montana—other than the 13 that are publicly-traded—with more than 500 employees.) Thus, we will assume that when we exclude public corporations, we are also excluding large corporations—rather than reducing the revenue stream both by the percentage of public and by the percentage of large corporations, as in the earlier calculation. Beginning with the figure, quoted in the first paragraph, of $215.5 million in gains from sales of all corporate securities, we multiply by the percentage of market value in privately-held (15.4%) and non-passive (79.7%) companies, calculating $215.5 X 15.4% X 79.7% = $26.5 million. This income stream is then reduced to the estimated 2% derived from Montana corporations, calculating $26.5 million X 2% = $530,000 in exempted income, which, multiplied by the current net capital gains rate of 5.9%, yields $31,270 of affected revenue per year, based on 2003 figures.

This figure will fluctuate widely, due to occasional large dispositions of stock of in-state companies, and changes in the national climate for capital gains realizations. **Montana's largest year for over-all capital gains realizations was 2000, when $1,259,720,000 ($1.26 billion) in capital gains from all sources was reported.** Multiplying, as above, by the percentages due to sales of corporate securities, and by the percentages estimated for securities of privately-held, non-passive and Montana-domiciled corporations respectively, that implies $1,259,720,000 X 27.25% X 15.4% X 79.7% X 2% = **$842,654 of income deducted** from sales of securities in Montana "qualified corporations" under the bill. That indicates **$49,716 of annual lost revenue, in the highest historic year, at the 5.9% rate.**

3. Timing of revenue effects. Furthermore, since only investments made after December 31, 2004 qualify for the proposed exemption, and since a holding period of 3 years is required, **even the small revenue amounts estimated above are not affected for at least the first 4 years after enactment.** To meet the holding requirement, **no gains can be realized earlier than tax years beginning in 2007; gains realized in that year would be reported, and qualified exemptions actually taken, no earlier than tax years beginning in 2008.** (Estimated tax payments made during 2007 would also be reduced.) Investments in small, non-publicly traded companies are illiquid—not easily traded. Such investments typically are held for 3 years and up. Only rarely will such an investment gain sufficient value to merit trading in less than three years. The holding requirement completely assures that there will be **zero** qualified capital gains realizations until the 4th, 5th and later years.

Beginning in the 4th and later years, then, approximately $50,000 per year (with an inflation adjustment) can be considered as foregone revenue from the highest historic level of gains realizations from sales of stock in qualified Montana companies, as defined in the bill.

4. Contingent long-term impacts. The possibility exists that exemptions provided under this bill may be invalidated as an unconstitutional burden on interstate trade, as defined under the Cuno vs DaimlerChrysler decision of the 6th Circuit Court of Appeals—if that decision is not mooted by an Act of Congress, and if it is further upheld by the Supreme Court. If exemptions were thus invalidated, Montana might be required under the "meaningful backward-looking relief" provisions of the Supreme Court's McKesson decision, to either back-collect taxes exempted under this bill, or to provide tax credits to those who would have received exemptions under the bill but for the fact that their capital gains realizations were from qualified corporations located outside Montana.
In other words, Montana might have to refund an amount equal to 5.9% of total capital gains realizations from all qualified corporations both inside and outside Montana, calculated as $7,350,000 per year under paragraph A.1., above, minus the realizations from qualified Montana

stocks that were already exempted. At the current net capital gains rate, that contingent liability would be ($7,350,000 – $530,000)(5.9%) = ($6,820,000)(5.9%) = **$402,380 per year in contingent liability, starting in the 4th year after passage.**

For that liability to be realized, not only must Cuno vs DaimlerChrysler be upheld and made applicable in Montana, but we must assume also that the Legislature takes no cognizance of that fact, and fails in the intervening 4 years to amend the Montana Code so as to avoid granting an improper exemption.

B. Positive Impacts.

Investments in small, privately-held companies are made in expectation of a return on investment, in the form of net revenues available to the equity holders. With small private companies, investors usually demand a relatively high return, in the 20% range,[7] meaning that every million of investment should generate at least $200,000 in net earnings (pre-tax profit).
For each $1 million increase in annual early-stage investment, in response to the incentive represented by the proposed tax exemption, some of the effects on other state revenue streams would be as follows:
$1MM valuation gain X 20% required return = $200,000 net corporate earnings gain
$200K net revenue gain @ 6.75% = **$13,500 annual corporation taxes**
$200K net revenue @ 2.5% net profit rate [8] implies $8MM gross revenue gain
8MM gross revenue, when sales per employee = $400,000[9] implies 20 added employees
20 added employees at $50,000 gross/year = $1,000,000/yr payroll gain
$1.0MM payroll X .95 = $950k taxable income X 6.9% = **$65,500/yr income tax**
20 employees, @ 400 sq ft. each, require 8,000 sq.ft. facility
8,000 sq.ft. bldg @ $125/sqft = $1,000,000 property @ 1% = **$10,000/yr property tax**

Net Impact. Ignoring gains in other types of tax (automobile, excise, licenses, fees, etc), the total indirect **positive revenue impact** from the items highlighted above is **$89,000 per year**, versus a **one-time revenue loss** from exempting the historic level of realized capital gains, at **$66,000 per year.** If both the losses and gains start in the same year, that's a return of the investment plus a 35% gain, in the first year [($89,000-$66,000)/$66,000.]

In addition, gains from increased earnings and employment would typically have been building up for two or more years prior to a sale event, such as an IPO or private acquisition. However, ignoring the indirect revenue gains in years prior to the sale: each year starting year 4, on the above assumptions, Montana would lose $66,000 from exempting the historical level of capital gains from Montana companies being sold. However, assuming that early-stage investments increase by only $1 million per year (about 17%) in response to the tax exemption incentive, the ongoing additional revenue stream from increased collections of income, corporate license and property taxes would accumulate at $89,000 per year: $89,000 the 4th year, $178,000 the 5th, $267,000 the 6th, $356,000 the 7th, $445,000 the 8th, etc. After 8 years (that is, 5 years of the exemptions actually being applied), the state would have lost $66,000 X 5 = $330,000 in capital gains tax, and would have gained $1.33 million of increased corporation license, personal income and property tax, for **a net $1 million revenue gain.**

The above analysis seeks deliberately to minimize economic gains and benefits, and to overstate potential tax losses from the exemption, at every point. A more realistic estimate of benefits would be far higher.

There is no simple, objective rule for calculating increased investment in response to this level of tax change; but conversations with investors and fund managers indicate that a doubling of current investment rates, to $14 million per year (an increase of $7 million per year) would be a minimal expected response. Over 5 years, that estimate equates to $35 million added investment, or about 635 jobs created—which would yield 7 times the positive revenue impact estimated above, or **$623,000 per year in cumulating revenue gains:** $623,000 the 1st year, $1,246,000 the 2nd, $1,869,000 the 3rd, $2,492,000 the 4th, and $3,115,000 the 5th, for 5-year gains of $9,345,000 versus losses of $330,000, for a **net gain of just over $9 million.**

Equally important, but more difficult to estimate, is the "virtuous cycle" effect of establishing successful growth companies, which in turn feed the growth of upstream and downstream supply-chain firms, and also generate their own spinoff companies, to create industrial clusters that further increase the state's attraction for additional investments and industrial relocations.

NOTES

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1 Larry Finch, Administrator, MT Dept of Revenue (letter dated Dec. 15, 2004), quoting total capital gains receipts from Office of Budget & Program Planning general fund revenue forecasting document for the 2005 session; quoting breakdown of capital gains receipts by category from a DOR internal study of 1995 and 1998 receipts.

2 Joel Popkin and Company, "Estimation of Small Business Wealth Contract # SBA-HQ-00-M-0715," Washington DC, September 12, 2002, p. 5.

3 $13.2 trillion total market value, Wilshire 5000 index stocks at 1/30/05, from http://www.wilshire.com/Indexes/Broad/Wilshire5000/Characteristics.html . Total equity issues at market value, quarter 3, 2004: $15.6 trillion, from Federal Reserve Flow of Funds, Table L.213 Line 1.

4 Smith Barney Citigroup, *Portfolio Strategist*, Feb. 24, 2005, Vol.23, No.8, p.13.

5 2002 and 2003 figures by US DOC, Bureau of Economic Analysis, BEA News #04-57, Table 1, p.4, from http://ceic.commerce.state.mt.us/Economic/BEA/GSP/gsp1204.pdf

6 This is a guess, which we've attempted to make on the high side. A figure for holdings of interests in MT companies versus total investment holdings isn't available readily. Dept. of Revenue has never made a breakdown between capital gains from MT versus non-MT companies. Securities firms contacted have been unable or unwilling to provide a percentage figure for the MT vs non-MT proportion of their client's portfolios, or gains realizations.

7 This is a rule-of-thumb figure widely used in bank debt finance underwriting, and in capitalized valuation of small, privately-held companies.

8 Average corporate earnings before interest and taxes (EBIT) from BizMiner.com national data for 2002, incorporated into Business Plan Pro application by Palo Alto Software. 2.5% is an average of figures for several prominent Montana industries by SIC code: 5031 Lumber & Mill Work; 2741 printing & publishing; 7371 computer software; 3556 food products machinery; 8099 medical services organizations.

9 Sales per employee from BizMiner.com national data for 2002, incorporated into Business Plan Pro application by Palo Alto Software. $200,000 per employee is the weighted average of figures for same industries listed for net earnings, above. Ratios of capital investment per employee, however, indicate a required investment of about $55,000 per job, and the higher figure has been used here. An alternate method of deriving jobs per gross revenues might be to divide total statewide private gross sales by total private employment, from BEA or BLS figures.

SB 511 Targeted Capital Gains Deduction
Critique and Response

1. *Objection: The tax deduction proposed in SB 511 violates the 6^{th} Circuit Court of Appeals ruling in Cuno v DaimlerChrysler [Cuno]. SB 511 provides an exemption to a Montana resident choosing an in-state investment, but no exemption to the same resident choosing a similar out-of-state investment, thus placing an "unconstitutional burden on interstate commerce".*

   Response:
   a. Cuno is not now applicable in Montana.
   b. Cuno is unlikely to ever become law of the land, applicable here; and if it did, would do so in an uncertain process, which might take several years.
      (1) Legislation (S.2881) is being drafted in Congress to negate the decision. All states having any form of in-state business preference will have an incentive to support S.2881, and a Republican-dominated Congress is likely to pass it.
      (2) In the absence of Congressional legislation, the decision is under appeal to the Supreme Court.
   c. So unlikely is Cuno to be upheld, that even states in the 6^{th} Circuit (such as Michigan) are currently introducing legislation that would clearly be invalid under that ruling. Should Montana be more timid than 6^{th} Circuit States on a 6^{th} Circuit decision?
   d. Finally, since our deduction applies only to investments made in 2005 or after, and requires a 3-year holding period, the earliest deductions are available in 2008, to be claimed on returns filed in 2009. We will have two Legislative sessions (2007 and 2009) before significant deductions are granted, in which to assess whether the Cuno decision will ever apply in Montana, and to amend the law if necessary.
   e. The legal argument under Cuno applies to "apportioned taxes," that is, taxes that are shared among different states (such as the income of a corporation conducting business throughout the country). The exemption under SB 511 applies only to capital gains on intangible assets (shares of stock). Intangible asset gains are always and only taxed in the tax home state of the seller, so revenues from such intangible sales are never shared or "apportioned" among states. For this reason, it is quite possible that the Cuno decision may not apply at all to SB 511, and SB 511 thus may not even be subject to a challenge under Cuno.

2. *Objection:* If Cuno is upheld and becomes applicable law in Montana, and if the proposed capital gains exemption were struck down as unconstitutional, then (under the doctrine of "meaningful backward-looking relief," established in the 1990 McKesson decision), Montana might be required to either collect back taxes from those who had received the exemption, or to provide tax refunds or credits from those who had been denied the exemption on investments that were made out of state, but would otherwise have qualified for the exemption.
   a. For the reasons noted above, this scenario is unlikely to occur.
   b. Because of the 3-year delay before exemptions can be earned, Montana has ample time to observe the progress of Cuno toward becoming law, and to rescind or amend the legislation if necessary, thus avoiding liability altogether.

c. In any case, the amounts at risk are very small, and pose no significant threat to the state. The only people who might be in a position to make a claim are those who make a qualified investment as defined, but place their investment in an out-of-state company. Qualifications include that a company must be a c-corporation, be small in size, not publicly-traded, and not a passive investor (such as a holding entity for real estate, financial instruments, or other assets held for speculation on price gains).
Of all capital gain income reported in Montana, 27% is from corporate stock. 28% of corporations are small, and about 15.4% are non-publicly traded. The current net tax rate on capital gains is 5.9%.
Applying those percentages to capital gains income reported in 2003:

\$791 million X 27% X 28% X 15.4% = \$9.2 million X 5.9% = <u>\$543,300 annual revenue.</u>

This figure would be further reduced by the percent of such revenue attributable to stock in Montana companies, which would have qualified for the exemption, and by income from sale of stock in finance, insurance and real estate (FIRE) companies (amounting to about 20.3% of all corporate shares), and from sale of stock in shell corporations, which would be disqualified as passive investors, without regard to geography.

In summary, <u>the risk amounts to approximately **\$400,000 of annual revenue, beginning in state fiscal year 2008 – 2009**</u>, when the first exemptions might be granted (and the first credits might be claimed by those not receiving the exemption). For any risk at all to exist, we must further assume that, in 4 years intervening between now and the time exemptions are first paid, the Legislature fails to take account of Cuno becoming law in Montana, and fails to amend the exemption accordingly. [SEE "Impact Calculations" file, attached, for full calculation of contingent liabilities]

d. <u>There are two ways to deal with this risk</u>—which is both small and distant in time.
(1) Pass the bill as proposed, and take account in the 2007 and 2009 Sessions of whether the exemption has become, or is very likely to become, unconstitutional. In this regard, the Legislature's responsibility would be no different than for any law on the books which might, at some time, be invalidated.
(2) Simply drop the in-state qualification, since the potential total revenue cost of exempting early-stage investment capital gains (about \$400,000 flat per year) is considerably smaller than the expected benefits (\$623,000 cumulating per year) from each \$1 million of added investment. This course would have the additional benefit of providing a very substantial incentive for active seed-capital investors now domiciled outside the state—those who earn most of their income from early-stage investment—to make Montana their tax home.

3. <u>*Objection:*</u> *SB 511, by providing special treatment for a certain type of income arising from a certain class of investment, violates the general principle of tax equity, which is that all income should be taxed equally. In principle, it is unfair.*

<u>Response:</u>

a. It is commonly practiced, legally permissible and ethically correct for states to encourage activities that are beneficial to the general economic welfare through favorable tax treatment.
b. Small companies positioned and organized for growth are the most powerful job generators in the economy.
c. The type of financing most needed by such companies (early-stage equity) is under-allocated to Montana due to a market failure, arising from high unit costs of information for investment decisions in this remote, underpopulated region.
d. Government intervention to increase Montana's investment allocation is justified and necessary to correct this market failure, <u>and far from violating principles of equity, in fact will act to restore fairness in the marketplace.</u>

SEE 1-page file, "CapGains Justification," attached, for expanded argument and economic evidence.

4. <u>*Objection:*</u> *The exemption offered is subject to manipulation. There is an entire tax avoidance industry, employing skilled professionals at large accounting and law firms, seeking ways to take advantage of laws such as this to provide tax benefits to unintended recipients, or recipients whose actions don't result in the benefits (job and revenue growth in Montana) intended by the law. For example, a large company like Montana Power a few years ago, might manipulate accounting statements and timing of sale to obtain a high price for stock held by executives before declaring a bankruptcy that destroys value for common shareholders—and in the bargain, obtain a tax exemption on the gains.*

<u>Response:</u>

This bill is well-structured to resist manipulation.

a. SB 511 is an exemption for a very particular type of income (capital gains on sales of stock in companies that are located in Montana, organized as C-corporations, and that were small (under 100 employees) and not publicly-traded when the investment was made, and are not passive investment vehicles for real estate or other assets held for speculation on price gains. Unlike a tax credit, which can be used to shelter any kind of income tax liability, SB 511 can only be applied to the narrow class of income above defined. The qualifying attributes are easily determined from information already held by the state, or available from federal tax returns.
b. Investors seeking to manipulate and shelter capital gains in general can do so much more easily and completely by locating their tax home in Wyoming, South Dakota, or Washington (for example), which have no income or capital gains taxes at all, then by attempting to bend the qualifications of the narrow exemption here proposed.
c. The requirement for qualified stock to be that of a C-corporation is a powerful discriminator. Passive, non-job-generating investment activities which might

seek shelter (for gains in real estate, collectibles, financial instruments and so forth) are explicitly prohibited in the bill; and in addition, by being forced to organize and report as a C-corp for at least 3 years, such activities would forfeit any benefit gained by the exemption, because of the double-taxation treatment of C-corporation earnings.

d. Large entities most able to avail themselves of tax manipulation schemes (companies that were over 100 employees and publicly-traded or listed when the investment was made) are not eligible for the credit.

e. Well-defined targeting limits opportunities for manipulation. Based on 2003 figures, only $600,000 of income and $41,500 of revenues would have been affected by the bill.

SEE Excel file, "CapGains Targeting 2003" for illustration of income and revenue affected.

5. Objection: it is unprecedented to exclude an entire broad class of income from taxation altogether.

a. The exclusion of income under this bill is remarkable for how narrowly and specifically it is targeted, aiming precisely at the single type of investment that is most productive for job and income growth (early-stage equity capital for small companies). *It is, in fact, anything but a "broad class of income" which is being excluded.*

In the year 2000 (Montana's highest capital gains year ever), out of total capital gains income of $1.3 billion, only $843,000 of income and only $50,000 in tax revenues would have been affected.

b. 3 of our neighbor states—Washington, South Dakota, and Wyoming—impose no income tax at all (certainly a "precedent for excluding a broad class of income"). The proposed capital gains exclusion is a modest, targeted measure that is rationally related to the creation of jobs and income growth in Montana.

6. Objection: if Montana doesn't collect taxes on capital gains from assets sold by out-of-state taxpayers, those taxes will simply be collected by the taxpayers' home states. There will be no incentive, because the same taxes will be paid. The only difference is that the tax will be collected by their home states, instead of Montana.

This claim is untrue. It arises from overlooking the fact that the proposed exemption affects only intangible assets (shares of stock are the only asset affected by this bill). Intangible assets are always and only taxed in the home state of the taxpayer—whether or not this bill is passed. This bill offers an exemption to a Montana-domiciled taxpayer, making an investment in a Montana-domiciled company. SB 511 has no effect whatsoever, positive or negative, on an out-of-state taxpayer.

Example 1—**tangible** assets owned out-of-state: a California taxpayer sells a lot on Flathead Lake, at a profit. The lot is a tangible, physical asset, which has a geographic location in Montana, so the sale is considered Montana income. The California taxpayer will pay Montana income tax on the gains, and will receive a credit for that payment on California taxes. (If the California rate is higher, the taxpayer will pay to California the excess tax above what Montana would charge). Nothing about this example will change if SB 511 is enacted, because SB 511 only affects **intangible assets.**

Example 2—**intangible** assets (stock shares) owned **out-of-state**: the same California taxpayer sells 100 shares of stock in a qualifying Montana company, at a profit. The shares are an intangible asset—a bundle of ownership rights. As such, they have no geographic location themselves, but are considered to be located in the tax home of the taxpayer: in this case, California. Profit from sale of the shares is California income, and is taxed at the rate paid on capital gains in California. SB 511 has no effect, because the seller's tax home is not in Montana.

Example 3—**intangible** assets (stock shares) owned **in Montana**: a Montana taxpayer sells 100 shares in a qualifying small Montana company, and makes a profit. Because it is a small, non-public, active operating company that is organized as a "C" corporation in Montana, no tax is due on the capital gains from this sale of stock. This bill is aimed only at stock investments made by Montana investors in small Montana companies; it rewards Montanans for making early-stage capital available to our own companies.

7. Objection: *The exemption is unfair to excluded classes such as companies which are locally-oriented (don't have more than half their sales out of state), or that might fail the definition of "value-added" (professional services, retail), or that choose for perfectly sound reasons to organize as S-corps, partnerships or LLC's.*

Response:

a. The few qualifications now remaining in the bill (location in Montana, organization as C-corp, small size and non-public when investment made, non-passive entity) are so powerful in limiting the class of income affected, that qualifications such as "basic" or "primary" industry (having most sales out of state) and "value-added" activity have been dropped. If a locally-oriented company requires and obtains equity investment to finance growth, organizes as a C-corp to facilitate doing so, and experiences a capital gain as the result of significant company growth, it will qualify--as will a service, retail, wholesale, utility, construction company or any other active producer of goods and services.

b. The requirement for organization as a C-Corp is not only an effective, but a well-justified mechanism for identifying the potentially high-growth companies that are the target of and the economic justification for this exemption.
   (1) High-growth companies absolutely require non-founder equity investments—rapid growth cannot be financed by debt, nor by owner injections (excepting wealthy owners, who don't require assistance).

(2) For companies that plan to grow rapidly, and to large scale, and that need to draw equity from a broad market, the C-corporation is the appropriate organizational model. Exceptions to this rule are rare, and likely all but non-existent in a small market such as Montana's.

(3) On the other hand, companies that do not require numerous shareholders, and do not expect to grow quickly or to large scale, will be deterred by the rigidities, costs and tax implications of organizing as a C-corporation. Slow-growth or no-growth companies, which as a class are not net job generators (in this class, job contraction equals or exceeds expansion), are not the targets of this exemption, and will self-select out of qualifying for it.

6. Objection: *The exemption offers no benefit to investors whose tax home is not in Montana—and the vast majority of all early-stage and venture capital is held outside the state, in enclaves such as Seattle, Boston, Silicon Valley and others.*

Indeed, this bill makes no attempt to offer subsidies or benefits to investors from out of state. The benefits of this bill are targeted to investors who live and make their tax home in Montana, and who place early-stage investments in growth companies that are also located here. Given the face-to-face nature of early-stage investing, which normally involves providing management expertise and industry relationships as well as money, the local investment community—while it may be small—is the most significant one. This bill gives that community an incentive to grow.

This bill does not pretend to be a comprehensive solution to the over-all market failure that yields under-investment in early stage ventures here. Montana must address the problem of attracting out-of-state investment, as well as building in-state investment. That comprehensive solution will have many components, of which this simple, straightforward and low-cost measure is one.