

STATE OF MINNESOTA
Department of Energy and Economic Development
Economic Development Division

In the Matter of the Proposed
Adoption of Rules Governing the
Certification of "Qualified Small
Businesses" and "Small Business
Assistance Offices" under Laws of
Minnesota 1983, Chapter 342 as
amended by Laws of Minnesota 1984,
Chapter 502, Article 5

STATEMENT OF NEED
AND REASONABLENESS

The Minnesota Department of Energy and Economic Development presents herein facts and justifications establishing the need for and reasonableness of the above captioned proposed rules.

Authority and Need

These rules are being developed under the general grant of authority contained in Minn. Stat. 14.06.

These rules are necessary since the statutory language relating to definitions and criteria used in the certification process described at Minn. Stat. 290.069 Subd. 1(a) - (f) does offer opportunities for confusion. These rules will:

1. Provide clear, uniform definition of terms used in the certification procedure;
2. provide clear notice of the procedures to be used in certification;
3. eliminate any concern that subjective or varying criteria might from time to time be applied to applications for certification.

4351.0100 Definitions

1. Scope. Definitions in this section provide common terminology and meaning for terms used in discussing and understanding the substantive provisions of this rule.

2. Business entity. The term business entity is defined to encompass organizations doing business as corporations, partnerships and proprietorships, except entities engaged primarily in providing licensed professional services and except entities engaged primarily in farming as defined in Minn. Stat. 290.09, Subd. 29(a). This is consistent with the statutory language and with

the legislative intent of making these tax credits widely available in order to encourage job-producing investments in qualified small businesses. The legislative intent was to make these credits widely available, with certain statutory exceptions. The exceptions are included in the definition of business entity in order to give potential applicants clear notice of them.

3. Employee. It is anticipated that a number of new small business start-ups will seek certification as qualified small businesses. It is very common to find in such start-up situations in which the officers of the new business take no payroll remuneration but do devote full time efforts to the business. Since the statutory definition of a qualified small business limits the number of possible employees, it is necessary to determine how such a situation is to be treated. Since the credits are to be widely available as an economic development incentive, it is reasonable to define employee only as a person on the formal payroll of the business. 1984 amendments to the statute require the number of employees for purposes of certification as a qualified small business to be determined on an "annualized full time equivalent basis." The term "annualized full time equivalent basis" is not defined in Minnesota Statutes. The definition thus clarifies how the number of employees is to be determined. The definition is consistent with the definition of "full time professional employee," Rule 4351.0100, Subpart 12, and uses 2080 hours as the number of hours worked in a year by an employee (40 hours per week x 52 weeks = 2080 hours per year). Overtime hours are excluded because overtime hours generally are worked by existing employees, and thus counting overtime hours in determining the number of full time equivalent employees could overstate the number of employees and thus potentially restrict the number of small businesses that could qualify for certification.

4. Subsidiary or affiliate. A subsidiary is normally understood to mean a corporation in which more than 50 percent of the ownership interest is owned by another corporation. Use of 50 percent is consistent with the 49 percent limitation on ownership contained in Minn. Stat. 290.069 subd. (4). The term "affiliate" does not generally have a common meaning. The use of the 20% ownership interest is an arbitrary one intended to reflect a degree of ownership less than that required for a subsidiary yet still sufficient to indicate more than minimal ownership. It is necessary also to consider that circumstances may arise where percentage ownership formulas may not apply. It is reasonable in that case to identify other facts such as contractual arrangements, shared management or directors, and fragmentation of ownership interests be included to reflect other means of control of the business entity.

5. Commercial domicile. This term has been used by the Minnesota Supreme Court to designate the state in which a corporation maintains a principal office from which it directs its business. (See e.g., Marshall-Wells Company v. Commissioner of Taxation, 220 Minn. 458; 20 N.W. 2d 92 (1945); Cargill, Inc., v. Spaeth, 215 Minn. 540, 10 N.W. 2d, 728 (1943). The definition has been included to clarify the term "commercial domicile" in Minn. Stat. 290.069.

6. Taxable year. 1984 amendments to the statute state that an applicant for certification as a qualified small business cannot derive more than 20 percent of its gross receipts from passive sources during one or more of the three previous "taxable years." "Taxable year" is not defined in the statute. The definition is consistent with the definition of taxable year in Minnesota Statutes 290.01 Subd. 9 and clarifies that the determining factor is the period of time for which the tax return was required, and not whether or not a tax is due.

7. In operation. 1984 amendments to the statute state that a business which is "in operation" for less than a year cannot be certified as a qualified small business if it intends or is likely to derive more than 20 percent of its gross receipts from passive income. "In operation" is not defined in the statute. The definition looks to whether the entity is engaged in the activities for which it was organized in determining whether it is "in operation."

8. Passive income. 1984 amendments to the statute limit the percentage of "passive income" an applicant for certification as a qualified small business may receive. In addition, an applicant for certification as a qualified small business is required to affirm that its passive income did not exceed statutory limits. The statute does not define "passive income." The context of the statute suggests the Legislature intended "passive income" to include royalties, rents, dividends, interest, annuities and sales or exchanges of stock or securities. The rule clarifies the apparent legislative intent.

9. Engaged primarily in providing licensed professional services. 1984 amendments to the statute state that a qualified small business does not include an entity engaged primarily in providing licensed professional services. "Licensed professional services" is not defined. The definition is consistent with the definition of a provider of licensed professional services contained in Minnesota Statutes 319A.01, Subdivision 2, pertaining to the organization of professional corporations.

10. Commissioner. The statute gives the Department of Revenue the authority and responsibility for the substantive operation of the tax credit program. The Department of Energy and Economic Development has the responsibility for the necessary certifications for eligibility to receive these credits. The definition of Commissioner is included to eliminate any confusion as to which commissioner is being referenced.

11. Audited financial statements. By statute, small business assistance offices are required to provide audited financial statements. This section simply provides further clarification of the statutory term "audited financial statements." The definition reflects the requirements of Minn. Stat. 325.165 on the delivery of opinions on financial statements.

12. Full time professional employee or equivalent. By statute, small business assistance offices are required to employ, at least, two full time professional employees or the equivalent as one of the conditions they must satisfy for certification. By statute, this requirement is satisfied if the small

business assistance office employs one full time professional employee and shares a professional employee with another organization engaged in related activities. This definition is needed to clarify the definition of "full time" by excluding individuals or firms retained from time to time on a fee for service or contract or consulting basis for less than 2080 hours per year. It is also needed to clarify that a "professional" employee must be directly involved in performance of services relating to the statutorily defined primary purpose of the corporation. The definition of equivalent means that it is possible and permissible to have full time equivalent employees as long as the total equivalent is two full time professional employees. The definition of a "shared" professional employee is addressed in Subpart 13.

13. Shared professional employee. By statute, a small business assistance office satisfies the requirement that it employ two full time professional employees or the equivalent if it employs one full time professional employee and shares a professional employee with another organization engaged in related activities. The definition clarifies that the shared employee must perform services directly related to the primary purpose of the corporation, and thus is consistent with the definition of full time professional employee contained in Subpart 12. The definition further clarifies that to be considered a shared employee, the individual must be paid by the corporation. This requirement is consistent with Subpart 12 which requires a full time professional employee to be on the payroll of the corporation. It also is consistent with Supart 3, which defines an employee (in part) as a person on the payroll of the business entity. The definition also clarifies that the "shared" employee need not be employed by a nonprofit corporation. The statute does not require such a limitation. To restrict the "shared" employee to employees of nonprofit corporations would unnecessarily limit opportunities for organizations to obtain the expertise of a broad range of resources.

14. Financing. The corporation cannot be engaged in providing financing or primarily engaged in arranging financing for businesses. As noted in the section of the Statement regarding comments received under Chapter 188, Laws of Minnesota 1983, many organizations which might otherwise qualify as small business assistance centers do provide below market rate loans. Likewise, they do provide assistance with securing grants or contracts. To disallow these forms of assistance would curtail an already existing form of assistance. By narrowly defining financing to mean market rate financing, the organizations will not be discouraged from providing creative alternatives to conventional financing that fit market gaps for working capital and equity.

Purpose

This section is consistent with recommended rule format of the Revisor's Office and clarifies the purpose of these rules. References to the Internal Revenue Code have been changed from the Internal Revenue Code of 1954, as amended through January 15, 1983 to the Internal Revenue Code of 1954, as amended through December 31, 1983 to reflect Instructions to the Revisor

contained in the 1984 Minnesota Session Laws, which instruct the Revisor of Statutes to substitute the phrase "Internal Revenue Code of 1954, as amended through December 31, 1983" for the words "Internal Revenue Code of 1954, as amended through January 15, 1983" wherever the phrase occurs in Chapter 290. 1984 Minnesota Laws, Ch. 514, Art. 1, Sec. 8.

Computation of Gross Annual Receipts

"Gross annual receipts" is not a term defined in Minnesota Statutes. To make this definition clear to our audience which will be composed of small businesses organized in a variety of forms, "gross annual receipts" is defined by reference to the computations and reporting on federal tax returns. Since these businesses are organized in different ways, it is necessary to enumerate the different tax forms, lines, and schedules involved.

Certification as Small Business Assistance Office

This section seeks to clarify the affirmative burdens which will be imposed on small business assistance offices which seek to be certified by the Commissioner. Subsections b, c and d, while repeating statutory language, are included so that all the necessary requirements will be complete and clearly shown in the rules.

1. Application. Because these tax credits are a benefit program rather than a regulatory program, the rules include only those requirements consistent with the statutory authority of the program. The use of an application by affirmation represents a simplified approach consistent with the intent of making the application process as easy as possible. The submissions to accompany the application (articles of incorporation, designation by the Internal Revenue Service as a 501(c)(3) organization and a payroll abstract) will evidence compliance with the statutory requirements of a statement of the primary purpose of the corporation, possession of 501(c)(3) status, organization under Minn. Stat. 317, and at least two full time professional employees or the equivalent.

2. Period of certification. The Commissioner will make certifications on a calendar year basis. Submission by November 15 will allow adequate processing time for the Commissioner's determination.

3. Annual application. The statute provides that the tax credits are available on an annual basis for tax years beginning after December 31, 1983. Since the criteria for eligibility are statutorily defined, and since small business assistance offices are free to change their function and form, it is necessary and reasonable that they reapply for evaluation each tax year.

4. Decision to certify. The 30 day period gives the commissioner adequate time to consider the application, taking into account the sections of Minn. Stat. 290.069 subd. (1)(a)(1-4), and approve the application if it meets these criteria. It is also adequate time to notify the applicant if the certification is disapproved. It is reasonable to state the reason for such disapproval.

4351.0500 Certification as Qualified Small Business

1. Application. In order to make the application process as easy as possible for applicants, an application by affirmation is being used. The language there repeats the statutory language about which affirmation is made. The submissions to accompany the application will evidence compliance with the statutory criteria.

2. Period of certification. Initial certification is for the calendar year 1984. The submission date of November 15 is reasonable to allow adequate time for processing applications at the end of the year.

3. Annual applications. There are many factors affecting eligibility for certification that may change in a year's period. A separate application each year allows the Commissioner to make a determination based on the current status of the business.

4. Decision to certify. Thirty days is adequate for the Commissioner to certify a qualified small business. Written reason for denial affords the applicant an opportunity to cure any defects in the application or know the reasons for the Commissioner's action.

4351.0600 False Information

This section is necessary because the department has streamlined and expedited the application process by relying upon the applicant as the provider of information. To maintain the integrity of the process, it is reasonable that there be a consequence to misrepresentation or omission.

Chapter 188

The tax credits available under Laws of Minnesota 1983, Chapter 342 as amended by Laws of Minnesota, Chapter 502, specifically involve small business. The credits are intended to stimulate the growth and success of small businesses through encouragement of transfer of technology to small businesses, equity investment in small business and contributions to small business assistance offices. Because the entire program is directed at small business, no special provisions or exceptions need to be enumerated. Rather, the proposed rules are formulated to accommodate the needs, capabilities and circumstances of small business.

I. Impact on Small Business

In considering the methods prescribed in Laws of Minnesota 1983, Chapter 188, Section 1, for reducing the impact on small business, it should be noted

that the proposed rules do not establish a regulatory compliance or reporting program with mandatory application to a particular business sector. Rather, the rules clarify policy and procedures for the operation of a benefit program, and the decision whether or not to participate in the program is voluntary. Thus, in one sense, the impact of the rule on small business is within their own control.

Even though the concepts of "compliance or reporting requirements" and "design or operational standards" are not, strictly speaking embodied in the proposed rule, the Department of Energy and Economic Development has addressed each method specified in Chapter 188, Section 1, to the extent applicable.

Less Stringent Compliance or Reporting Requirements

There are no reporting requirements for small business. While the application process is not, strictly speaking, a "reporting requirement," the Department of Energy and Economic Development has taken a less stringent approach to informational requirements in the application process than is typically used in similar programs. Application is by affirmation that the statutory criteria are met together with the minimum documentation necessary to support the application.

Because it is a benefit program, rather than a regulatory program, the rule clarifies eligibility requirements for the Commissioner's certification rather than compliance requirements. The Department has adopted the least stringent eligibility requirements consistent with statutory authorizations of the program.

Schedules for Compliance or Reporting.

There are no reporting schedules determined by the proposed rule.

Simplification of Compliance or Reporting.

Viewing the application process as a "reporting requirement," the Department of Energy and Economic Development has adopted a very simplified approach. The proposed rule provides that the Commissioner will make available application forms for certification for qualified small businesses or small business assistance offices. The use of these application forms will help small business applicants define the precise information necessary for certification and will assist the applicant in organizing and presenting the application data in its most favorable light. The information required on the application is limited to that information necessary for the determination of eligibility. Thus, both the structure and content of the application requirements are designed to simplify the process for small businesses and small business assistance offices.

Performance, Design or Operational Standards.

The proposed rule does not contain any design or operational standards; therefore the Department of Energy and Economic Development did not consider the substitution of performance standards in lieu thereof.

Exemption of Small Business from Rule Requirements.

As previously discussed, the entire tax credit program is intended to benefit small businesses and small business assistance offices. Thus, all of the proposed rule requirements are promulgated with the capabilities and needs of small business in mind. Further, the requirements adopted in the rule are minimal and necessary to fulfillment of statutory requirements and standards. Further exemptions are neither appropriate nor authorized.

II. Small Business Participation in Rulemaking.

1. The Department of Energy and Economic Development and the Department of Revenue published a joint notice of intent to solicit outside opinion regarding the development of these rules. This notice included a statement regarding the impact of the rule on small business. That notice appeared at 8 SR 970, Monday, October 24, 1983.

2. Notification was made to those bodies generally recognized as related to small business (e.g., AVTT's, small business development centers, chambers of commerce).

3. Direct notification of many small businesses that might be interested in the rule was made.

4. Publication of notice about the credits and 1984 amendments to the statute were made in newspapers and magazines of general circulation (e.g., Minnesota Small Business Newsletter, Winter 84; Citibusiness, January 18, 1984; Minnesota Business Journal, June, 1984).

5. Two public meetings were held, specifically targeted to small business. One was November 21, 1983 in the Twin Cities (Control Data's Business and Technology Center) and the other November 22, 1983 in Duluth (Control Data's Business Center). Transcripts of the public meetings are part of the rulemaking record. Public meetings were not held following the 1984 amendments. The amendments did not change the substantive requirements of the certification process.

Below is a summary of comments received during the public meetings and the Department's response:

Comments Relating to Definition and Certification of "Small Business Assistance Office

COMMENT: Diane Weber, Grand Rapids Business and Technology Center. The statutory definition of "small business assistance office" should be expanded to include not only 501(c)(3) corporations but also 501(c)(4) corporations.

RESPONSE: Such change is beyond the scope of rulemaking and will involve statutory amendments.

COMMENT: Ron Dysveck, Peoples Community Enterprises, Duluth. The definition of "providing financing" or "arranging financing" on the part of small business assistance offices should be written in such a way that it would allow existing loan programs of various assistance offices to remain in place.

RESPONSE: The Department has written the definition of financing as the making of market-rate loans. The definition was also written so as not to include assisting with the securing of grants or contracts from public or private sources.

COMMENT: Wallace Baker, Duluth Cooperation Office. Non-cash contributions to small business assistance offices should be eligible for the tax credit.

RESPONSE: This subject is beyond the scope of this department's rulemaking under the statute.

Comments Relating to Definition of "Qualified Small Business"

COMMENTS: Ted Johnson, Minnesota Cooperation Office. Firms should be able to qualify at time of organization—even if they have no employees, products, or sales at that time.

RESPONSE: The statute does not require businesses to have employees or products or to conduct business at the time of seeking certification.

COMMENT: Oscar Lund, Private Business Consultant. The definition of "subsidiary" or "affiliate" should be written sufficiently narrowly that independently owned franchises do not fit the definition.

RESPONSE: The definition has been so written that a separately incorporated franchise is not a subsidiary or affiliate.

COMMENT: Ed Lambert, Duluth. Tax credits should be allowed on equity investments less than \$25,000 to make it easier for small firms to attract more capital.

RESPONSE: Such a change is beyond the scope of rulemaking and will involve statutory amendments.

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