

Background

For nearly all of human history people could succeed in their local region as long as they possessed skills that were above average within their region in their field of specialty. In just the last few decades that has started to change and now nearly every person must be competitive not just regionally but globally.

After millennia of isolation the world has become global driven by technological advances. Communication, transportation and immigration are the drivers of globalization. Globalization has improved the world's gross output and the world's standard of living on average. However, there are groups that are negatively impacted, as efficiency becomes the driving force in every area of life.

What can any national or regional economic or political entity do to ensure that its population does well in this global environment?

Nations and political and economic entities within nations must ensure that their region is globally competitive in their regionally dominant areas of economic activity. A population can be highly paid as long as its work output is more efficient than others when measured in terms of output per unit labor cost.

If certain nations or regions fail at being competitive they will experience a decline in their standard of living while other regions advance. Failing to be competitive will result in a lowering of the quality of life. Prosperous businesses create financial resources in terms of payrolls, subcontracts and tax payments by a business, its employees and suppliers. Tax payments enable municipal, county, state and federal governments to provide services and safety that establish the basis for a quality of life.

Even fields that were once considered immune from globalization are changing. For example certain countries are beginning to develop less expensive major surgery centers to attract cost-sensitive patients (or their insurance companies) to travel to those centers for major surgery. This was not considered feasible even a year or two ago.

The US has done very well in creating many technologies that have advanced the quality of life around the world. The US still leads in creating new technological breakthroughs but that lead is shrinking and the US should do better in order to maintain that lead.

Entrepreneurs in the US have research and converted it to commercial products and services. That is a hallmark of US culture, especially in California. The top US companies in the Fortune 500 have reduced their employment nearly every year over the past two decades and that will continue. New startups are the growth engine for the US, and especially for California. Startup companies have made the US great.

Commercialization in the US and in California is now threatened by regulatory and other changes. Some of those changes are reactions to a few egregious cases of greed such as Enron or Worldcom. Unfortunately regulatory results are not only working to prevent similar abuses at major corporations but are causing small business to slow. Innovation and commercialization should be made the centerpiece again.

There are many legislative policy and regulatory changes that could improve US potential for leading technological commercialization in general and California in particular. The following items were initially developed as part of the role of Mr. Helfrich on the Blue Ribbon Task Force on Nanotechnology (BRTFN) www.blueribbonnano.org. These items have been expanded to cover many of the leading technological development areas, especially fields that require more extensive activity such as hardware development, biotechnology, and personalized medical care. These and similar fields can be expected to provide strong business and employment growth in skills where US productivity enables high wages.

The items below are an initial set of actions that would help technological startups if implemented appropriately. The changes must be implemented with care and understanding so that it aids competitiveness without inviting abuses.

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Summary of Proposals

The brief summary below provides a listing of proposals to start the US and California back towards their peak of innovation.

Federal Changes

1 Promote Spinouts and Startups from Federally-Funded Research

Issue: The federal government spends tens of billions each year on research and development (R&D) with a rare small percentage of research ever reaching commercial markets. As a result some federal spending for research fails to benefit the government or the nation due to less than ideal technology transfer and a shift in private equity capital. Increasing tech transfer to enable a small increase in new sustainable commercial businesses above current levels would have a large impact on the US economy. There is no shortage of ideas or technology but there are limited resources and capital available to make the transition to the first stages of a commercial business possible. After the first stages of transition the private equity markets can and do a good job of commercialization.

Solution: Create new legislation that expands venture-type activities through independent venture capital entities funded by federal departments, centers and agencies as well as greatly increasing the number of centers that promote technology transfer such as National Science Foundation Centers of Excellence.

2 Provide Tax Credit For Individual Investors In Privately Owned Companies

Issue: There is a need for larger angel investments in startups that may require 5 or more years to reach an initial public offering (IPO) or other exit. This need is especially critical for most high potential startups in areas such as nanotechnology, alternative energy, biotechnology, personalized medicine and semiconductors.

Solution: Provide a federal tax credits of up to 20% for individual investors that purchase newly issued restricted equity securities in privately owned companies that is held for 4 years. This tax credit should include investments in venture funds of \$100M or less when those venture funds invest a majority of their capital in technological based startups that have fewer than 35 employees and less than \$10 million in assets.

3 Increase Limit on Losses from Qualified Small Business Stock

Issue: There is a need for larger angel investments in startups to cover the cost of most high potential startups in areas such as nanotechnology, alternative energy, biotechnology and semiconductors. The rate of success of these startups ranges over a low single digit percent. A qualified angel investor may make 20 such investments because it is hard to pick winners, even if the investor is highly skilled. These categories of startups need serious angel investors that invest \$50K and hopefully much more per investment. These scarce and critical investors need encouragement to continue to make investments after the bubble burst of 2000 and many angels withdrew from investing in technological areas that take 5 or more years to commercialize.

Solution: Change the limit on losses from investments into qualified small business stock from the current \$100,000 to \$1,000,000 to encourage angels to fund more startups.

4 Expand the Small Business Innovation Research (SBIR) Program

Issue: The level of funding provided by the SBIR program is fixed at 2.5% of research and development (R&D) spending at federal agencies. Grants to small businesses are not adjusted for higher costs and longer development times for hardware systems, nanotechnology, biotechnology or similar areas compared to other fields such as software.

Solution: Increase the level of Phase II SBIR program awards for complex technological products and add an additional phase (call it Phase IIc) for small businesses that are developing complex products for large commercial markets. Focus added SBIR funding and program management into the National

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Science Foundation (NSF) which provides the broadest coverage of technological areas and the most commercially focused approach.

5 Shorten Holding Period for Tax Advantages on Small Business Stock

Issue: There is a shortage of early-stage investors including both institutional investors and angel investors. Additional measures are needed to encourage more early-stage investments. Many companies funded by early-stage investors create products for global markets. The cost of entering global markets has become orders of magnitude higher than product development. In many cases investors are frequently better off selling these classes of companies in less than 5 years to a large entity that can address global marketing and distribution. While angel investors hope for an IPO when making an investment, many understand that the odds of an IPO are less than 1 in 1000. Therefore angel investors would be encouraged to invest if there were a benefit that covered the majority of successes, especially with the rate of even modest success averages 5% or less.

Solution: Reduce the holding period for tax advantaged sales of qualified small business stock from 5-years to 3-years.

6 Provide Expanded Deductibility for Relocation Expenses Improving Flexibility

Issue: There are regions of the US that have high unemployment rates and other regions that have a shortage of skilled workers. The costs of relocation prevent many individuals from filling those positions or employers from considering applicants outside their region. Former Fed Chairman Greenspan has claimed the strength of the US economy is flexibility. Allow regional labor surpluses a less costly opportunity to move their domicile to enhance US flexibility and improve US GDP growth.

Solution: Allow deductions for actual relocation expenses when starting new employment more than 100 miles from home to enable and encourage a larger percentage of unemployed individuals to take new employment opportunities far from their current location with other regulatory changes on compensation and expense deductions for businesses.

7 Allow Venture-Backed Startups to Meet SBIR Qualifications

Issue: Many of the most promising startups have venture funding and, under current market conditions, these startups frequently have most of their voting equity held by VC firms. That ownership disqualifies them from Small Business Innovation Research (SBIR) awards, which is counter intuitive.

Solution: Allow startups to qualify to bid on SBIR contracts when venture capital firms own over 50% or more of equity of a startup as long as the majority of venture investment is not controlled by one corporation and its affiliates.

8 Establish Retraining Program for Experienced Scientists in Declining Fields

Issue: There are hundreds of thousands of unemployed or underemployed professionals with ten or more years of industry experience, along with a master's or doctorate degree, in some fields of science and engineering that are declining. Meanwhile there are fast-growing fields of science and engineering with a shortage of skilled professionals and these growing fields are turning to foreign nationals to fill those positions.

Solution: Set up a formal special post-doctoral type fellowship financial support program and federal loans for unemployed scientists and engineers in specialty fields that have a high nationwide unemployment rate with the goal of retraining those professionals for new careers in fields with high demand.

9 Restore Program for Small Business Investment Companies (SBIC)

Issue: Each year a larger portion of institutional capital targeted to private equity funds shifts towards real estate, hedge funds, leveraged buyout funds and later stage venture funds. Compounding this situation is the trend in large venture capital funds to make private investments into public equities (PIPEs). The situation is especially severe when biotech (which can employ large blocks of capital in

a single drug development project) is excluded from the venture capital analysis. The result is less and less funding of early stage venture capital funds.

Solution: Bring back the Small Business Administration (SBA) program for Small Business Investment Companies (SBICs). This SBIC program allows small venture funds to gain the added capital needed (2 to 1 matching by the SBA) to fund biotech, nanotech and similar complex technological startups. Those are startups that offer the greatest promise of large scale high quality employment and those startups require a higher levels of funding as well as longer term funding to achieve revenue than many other types of startups.

10 Adjust Patent Issuance and Defense Regulations

Issue: The legal expenses involved with defending a patent against a large company's claims; or enforcing a patent against a large company that may be infringing a patent; cost several million dollars per patent when taken to a court trial. A compounding factor is the negative influence of patent trolls (groups that create no value but acquire a patent portfolio with the intention of squeezing money from businesses that are creating value).

Solution: Establish a better system for patent validation and patent infringement determination. Such a system may include a combination of independent peer reviews and special masters that could reduce costs for discovery and pre-trial activities along with an accelerated court judgement and settlement process. Also require patent judgements be based on damages from lost revenue and profits to businesses that are making products using those patents.

11 Change Lifetime Limit On Reduced Tax For Small Business Stock

Issue: There are far fewer angel investors left after the dot com bubble burst and those investors need to be encouraged to make many investments in high risk areas such as nanotechnology and complex crossover technological fields that may include advanced materials and alternative energy.

Solution: Change the lifetime limit on gains from qualified small business stock from a lifetime limit to a 3-year rolling limit to encourage serial investors.

12 Create Sarbanes-Oxley and Similar Rules Exemptions for Microcap Public Companies

Issue: The costs of Sarbanes-Oxley and other regulations are overwhelming for most small public companies. These costs block many potential initial public offerings (IPO) opportunities for startups. In many cases Sarbanes-Oxley regulations also reduce the opportunity for mergers and acquisitions of small companies by large public companies as those large companies are fearful of acquiring a small public company that has not fully complied with Sarbanes-Oxley and other regulations.

Solution: Exempt businesses with less than about \$80M in assets and \$80M in annual revenue from some or all of the Sarbanes-Oxley regulations and exempt companies that are acquire small public and private businesses from those same regulations for about 2 years to allow a transition period.

California Specific Changes

C1 Provide Tax Credit for Individual Investors in California Private Companies

Issue: There is a need for larger angel investments in startups that may require 5 or more years to reach an IPO or other exit. This need is especially for most high potential startups in areas such as nanotechnology, alternative energy, biotechnology and semiconductors where exits typically require 7 to 9 years after the initial investment.

Solution: Provide California tax credits of 30% for individual investors on newly issued startup stock in privately held companies. To qualify a company should have 70% or more of their workforce in California. That stock should be held for 4 years for a 30% tax credit. The tax credit should increase to 50% on startup stock that is held for 8 years or more. This tax credit should apply to investments in California venture funds of \$100M or less that invest a majority of their capital in technological based startups in California that have fewer than 35 employees and less than \$10 million in assets.

C2 Provide Tax Credits to California Businesses for California Investments

Issue: California has one of the highest costs of doing business of all 50 states. That high cost allows other states to poach California businesses, especially startups, by offering tax incentives such as tax credits, tax holidays and other benefits. Startups in particular have been and continue to be the source of incremental jobs, economic growth and nearly all growth in tax revenues for California.

Solution: Provide an R&D tax credit for investments made in California covering facilities, equipment, labor and other costs associated with research and development

C3 Expand Science and Math Education for California

Issue: California students are not trained sufficiently in science and math at the K-12 level. This has resulted in a reduced number of California high school graduates entering colleges and universities with science and math majors. While most Californian's agree that future jobs in California will require extensive science and math skills, we are not training our children sufficiently to fill those jobs. Equally important we are not providing the skilled teachers with science degrees that bring excitement to science, which is needed to motivate children to consider science as a career. Many of our new scientists and engineers in California must be imported from outside the United States.

Solution: Set minimum daily levels of instruction in science and math for all K-12 students and improve science and math teaching capabilities. Science should be taught 1-2 hours per day and math should be taught at least 1 hour per day.

C4 Exempt Selected Capital Assets from Sales Tax

Issue: The fields in which the US can grow employment and GDP tend to require both highly skilled professionals and capital assets. California tends to push these operations (which may be the major employment portions of business) to locate in other states due to sales tax on the purchase of those capital assets.

Solution: Waive California State and Local sales taxes for businesses based in California purchasing capital equipment to be situated in California for as long as that equipment remains in California.

C5 Conform California Tax Regulations and Accounting to Federal Regulations

Issue: The added costs and complexity of independent tax regulations such as depreciation to startups in complex fields (such as biotechnology, crossover technologies and nanotechnology that have high capital equipment needs for many types of capital equipment) make California less attractive to those startups. These are the very startups that fit the cost structure of California due to the high value creation per employee. In the past many entrepreneurs from other states and countries moved to California to form their startups. With improved communications and transportation it is practical to have a startup outside California.

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Solution: Conform California laws on tax treatment to federal law for small businesses with revenue and assets under \$50M to reduce costs and complexity for these companies that are creating most new jobs.

C6 Conform California Environmental Protection Regulations To Match Federal

Issue: The cost to small business from the myriad of regulations from California on top of regulations at the federal level helps push startups to locations outside California. In some cases there are municipal and county environmental regulations and reporting requirements on top of federal and state requirements. This is driving business out of California and causing some California businesses to set up operations elsewhere such as Nevada.

Solution: Conform California EPA and other regulations to match US federal regulations for businesses with revenues and assets under \$20M per year that have been in operation for less than 10 years. Also create a statewide California uniform county and municipal environmental code and reporting system suitable for a very small business.

C7 Reduce California State Regulatory and Filing Requirements

Issue: California requires more filings from businesses than most other states, encouraging businesses to locate outside California.

Solution: Exempt small businesses with assets and revenues under \$10M from certain California state filing requirements. Create a statewide California uniform county and municipal filing system with one set of standards and forms for all cities and counties.

Background for Each Proposal

Federal Changes

1 - Promote Spinouts and Startups from Federally-Funded Research

Create new legislation that expands venture-type activities through independent venture capital entities funded by federal departments, centers and agencies. The Central Intelligence Agency (CIA) has been able to establish a small venture fund activity to fund startups as an independent entity. Many other federal agencies want to emulate the CIA but are hamstrung by legal and regulatory issues. These venture capital entities should not only directly serve the mission of a specific agency, but also allow each agency to fund spinouts and startups that will commercialize technology which had already been funded by that agency. These funds should be focused on seed and first round investments in startups that are considered not ready for investment by commercial venture capital funds.

In parallel with that effort there need to be more centers whose role is mainly technology transfer and the incubation of startups and spinouts from federally funded research. The National Science Foundation currently funds several of these centers that offer focused areas of excellence for groups of universities and federally funded research centers. Additional centers should be focused on emerging technological fields and built around coalitions of universities and federally funded research centers with involvement of industrial partners (that may be small businesses) within a geographic region that allows daily interaction and movement of personnel among facilities. A region may be a state, a portion of a larger state, multiple smaller states, or logical geographic regions that may encompass portions of two or more states. One region may have multiple centers if there are sufficient fields of expertise and a large base of universities with many students and a substantial professional workforce. A goal of well over 100 centers of excellence is justified for the US with the National Science Foundation as the logical home.

2 - Provide Tax Credit for Individual Investors in Privately Owned Companies

Overall venture capital levels are at high levels measured by any historical yardstick. Capital under management is near an all time high. However both the percent of capital and the level of capital allocated to seed investments are at or near an all time low when adjusted for inflation. A major cause of this shift is the concentration of venture capital into a small number of very large venture funds. These large funds have small teams of managers that can only handle a modest number of investments per year. As a result these large funds are making very large investments. Such large investments are only justified in companies that have revenue and are close to profitability.

At this stage of global technological competitiveness sectors that offer the most promise are into companies developing very advanced products for which the US has advantages. These product areas include fields such as biotechnology, nanotechnology and complex combination technologies that include two or more technological fields such as a combination of advanced materials and alternative energy technology or medical device technology and advanced materials. We can expect that these complex fields will require 7 to 9 years before an investor can expect to achieve results or even to have access to his invested capital. Therefore a need for sources of small investments (investments of \$4M or less) of patient capital are needed to augment the new venture paradigm.

Individual angel investors, angel groups and small venture funds are possible solutions. Since the bubble of 2000 burst this class of investor has moved away from this category of investment. There is a need for larger angel investments in startups that may require 5 or more years to reach an initial public offering (IPO) or other exit. This tax credit should include investments in venture funds of \$100M or less that invest 70% or more of their capital in technological based startups that have fewer than 35 employees and less than \$10 million in assets.

3 - Increase Limit On Losses From Qualified Small Business Stock

A limit of \$100K on losses on the sale of small business stock is too low. Startups developing hardware for sale (which applies to many nanotech startups) require significant levels of seed funding. In many cases, seed funding of \$1M to \$3M is a useful level to consider. At this point, there are still very substantial risks that investors must be willing to take to make those investments. Historically, less than 10% of these investments pay off. In leading technologies where the US has advantages over other countries, startups that reward investors are frequently in the range of 2% to 5% of investments at best. Those that do pay off can provide large returns from startups that grow and create many high-value employment opportunities. Many NASDAQ companies having started with angel seed financing. Over the last few years the amount of angel funding has collapsed for hardware startups, in spite of the \$100K ordinary loss write-off. Some high-net-worth individuals are still willing to be angel investors in startups, but their numbers are few. Angels are now being very selective and mostly invest in startups where they personally know the founders. Most startups in complex technological fields need to raise \$1M or more in seed funding. It is more likely that there are a very few investors willing to put in as much as \$500K. It is nearly impossible to find 10 or more investors to put up \$100K each. Changing the limit of ordinary loss deductions for small business stock to \$1,000K would help these startups raise the funding they need from the limited pool of angel investors.

4 - Expand the Small Business Innovation Research Program

The SBIR program has been a great help to startup companies. The SBIR program now offers Phase I, Phase II and a limited-matching Phase IIb series of grants to small businesses. This has been a good approach for companies developing less complex product offerings such as a software package. There is a need for an additional Phase IIc program for small businesses that are developing complex hardware, such as nanotech based products.

Startups developing hardware, such as medical equipment, electronic devices and other systems, need to create a working prototype to attract venture capital funding. The existing funding levels of SBIR fall far short of the level needed to create revolutionary new hardware prototypes. The SBIR program already indirectly requires all startups to have outside funding due to the time lag between proposal and funding as well as gaps of typically 6 months between funding of the SBIR phases. This alone is a challenge for startups without a working hardware prototype.

The dollar limits of Phase II are useful for many startups but not for companies developing revolutionary hardware. This funding should be restricted to companies that have successfully completed SBIR Phase II programs and selected under a peer review program such as that now used by the National Science Foundation for Phase II award selection. For the best of the successful SBIR startups there could be an additional program within each agency or region of the US to provide special funding from a government backed venture capital fund such as the venture fund In-Q-Tel, funded by the CIA.

The logical place to focus this Phase II and Phase III SBIR activity is in the National Science Foundation (NSF). NSF frequently provides the best overall commercialization rate due to its independence from a dedicated mission like other federal agencies. NSF also provides a more commercially minded selection process using peer reviews by independent panels that include commercial/industrial experts along with academic reviews.

5 - Shorten Holding Period For Tax Advantage On Small Business Stock

5-Year Holding Period for Reduced Tax on Gains Too Long

5 years is too long for some angel or VC investments, especially for hardware producers. Most hardware startups in areas related to nanotech should be seed-funded for \$1M or more. These startups can get products ready to introduce to market for a few added million in investment. However, it takes tens of millions or more to make a credible market for these types of products.

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In many cases, it is better for angels and seed VC investors to consider selling the company to a large enterprise in less than 5 years after an investment. However, due to the very high risk of these seed investments, there have been fewer of these investments in hardware startups. A tax break should encourage angels to put more funding into these companies. It is also important to avoid the issue of tax savings negatively impacting business decisions. In many cases, it makes sense to sell out a business after 3 to 4 years if it becomes important to address a global market ahead of competitors outside the United States. Investors may be deluded into holding out to get the 5-year tax break and inadvertently reduce the potential of a startup company's market outside the US. That is not only a loss to the startup, but more importantly to US exports.

Some companies will take that long route and build a major business and achieve an initial public offering on the NASDAQ market. Statistical data on NASDAQ technological company IPOs over the last several years indicates a NASDAQ IPO has become a rare occurrence. In many cases investors are frequently better off selling these classes of companies in less than 5 years to a large entity that can address global marketing and distribution. While angel investors hope for an IPO when making an investment many understand that the odds of an IPO are less than 1 in 1000. Therefore angel investors would be encouraged to invest if there were a benefit that covered the majority of cases meaning an acquisition in about 3 to 4 years.

6 - Provide Expanded Deductibility for Relocation Expenses Improving Flexibility

Allow deductions for the ancillary cash costs of relocation to enable a larger percentage of the unemployed to take new employment opportunities far from their current homes. These costs include items such as temporary housing at the new location while selling a prior residence; storage of household goods while waiting for purchase of a new residence; travel to the new location prior to the start of employment to look for a new home; closing costs (not including points on a new mortgage) on the purchase of a new home; closing costs on the sale of the prior home including commissions, extra childcare expenses during the relocation period; spousal re-employment costs; and other costs that have become customary when an individual relocates to a distant area for a new career.

The US did allow this type of worker flexibility in the past with expanded deductible costs from relocation. That relocation flexibility helped fuel the shift in workers to growing areas in the West and in the South. There are emerging trends that require worker relocation flexibility in all directions. Some older regions of the US are attempting to grow into new technology areas but existing tax laws make the cost of relocation to the company and to individuals extremely costly. Workers and their new employers are saddled with high expenses but lack the ability to deduct many of those costs from their taxes. This has resulted in worker shortages in some US regions and workers taking employment in fields available in their own local area, which makes them underemployed. This not only hurts the workers and companies but also impacts US competitiveness in a substantially negative manner. Flexibility is the greatest strength of the US economy and all aspects of flexibility should be not only maintained but also strengthened.

7 - Allow Venture-Backed Startups to Meet SBIR Qualifications

Many successful companies have been able to get through their early stages though grants from Small Business Innovation Research (SBIR) grants as well as angel investments. Many of the most promising startups manage to also bring a syndicate of small venture capital funds. These venture backed seed stage startups tend to have a better team. Unfortunately, once that startup accepts venture funding from that syndicate that startup cannot bid on SBIR grants. This is not in the best interest of the US and not the best and highest use of SBIR funding. Regulations should be changed to allow startups to qualify to bid on SBIR contracts when venture capital firms own over 50% or more of the equity of that startup, especially when 2 or more firms jointly own more than 50% of the equity. These venture-backed startups should still meet all other tests for SBIR awards.

8 - Establish Retraining Program for Experienced Scientists and Engineers in Declining Fields

Professional scientists and engineers are the creators of value that are the engine of growth for the US. The US has a shortage of individuals with these skills and has been required to import skilled workers. Meanwhile a substantial number of US professionals are being made obsolete as offshore workers supplant their profession or as their skill sets become obsolete.

To counter that the US should establish a formal special post-doctoral fellowship financial support program for unemployed scientists and engineers in specialty fields that have a relatively high nationwide unemployment rate compared to other professionals. The goal of this program is to provide new careers to professionals in fields with high demand whose specialties are no longer sought after by employers.

As technology changes, it opens up opportunities for scientists and engineers who have specialized training and degrees. Sometimes that specialized training in selected fields becomes obsolete after 10 to 20 years. The rapid pace of technological change causes companies' skill requirements to shift to newer specialties.

One viable approach to filling the needs of companies with these no-longer-needed professionals is to establish a program similar to a post-doctoral program that would last from 1 to 3 years as determined by a university. The post-doc type program would provide payment of fees to the university along with a living allowance that would be higher than a normal post-doc program. These expanded funding levels allow professionals with families and family expenses to participate.

This program should be targeted to scientists and engineers who have at least a master's degree, 10 or more years of industry experience, and are unemployed. This type of program would allow more US citizens to fill positions for the newer fields that are now going to citizens of other countries who emigrate to the US. This type of program will become more important over time as people live longer and spend more years working, while at the same time technology changes faster so engineer and scientific professional careers will rarely continue for an entire working lifetime.

To keep the cost of this program reasonable some portion of the fellowship money should be made as a student loan similar to existing student loan programs but allow these retraining students to continue to own houses and/or other assets and qualify. It should be beneficial to have these retrained scientists and engineers qualify for loan forgiveness if they serve 2-years or more as secondary school science teachers after completion of their retraining.

9 - Restore Program for Small Business Investment Companies (SBICs)

Bring back the SBA program for Small Business Investment Company (SBIC) to allow small venture funds to gain the added capital needed (2 to 1 matching by the SBA) to fund nanotech startups that tend to require a higher level of funding. The SBIC program of the SBA made a profit for the government every year until the dot com bust and will likely be able to do so in the future as long as expanded investing during any future bubbles are avoided. SBICs have been and could be major sources of venture capital for early-stage startups that are developing higher-risk revolutionary technologies such as nanotech and similar fields.

This SBIC program was dropped after it had its first losing year when the tech bubble of 2000 burst. Overall the SBIC program has achieved a profit. Part of the loss was due to a limited set of criteria used to select funds that qualified for SBIC status. Selection should not just be made based on a checklist of criteria but should use outside panels of experts. To further enhance the SBIC program the selection of funds to be approved for SBIC status should be made by independent panels modeled after the SBIR program at the National Science Foundation.

10 - Adjust Patent Issuance and Defense Regulations

Current patent law favors entities with deep pockets (whether US or foreign) due to the cost of patent defense or patent enforcement and the extended time period from patent filing to issuance. The differences with international patent application and prosecution procedures also cause additional costs to achieve patent protection on an international basis.

Patent claims for damages should be limited to prevent patent trolls from using the system to stifle innovation. Patent trolls are entities that do not make or sell products or provide technological services and do not spend on research and development to create new technology and tend to employ few workers with science and engineering skills. Patent trolls typically acquire patents and use those patents to extort settlements from companies that are building a real business to sell products.

There are several areas of patent that should be modified. These modifications can be implemented using any one of several approaches. There are likely to be many side effects to any patent law changes, so a very detailed review of the possible unintended outcomes of any changes should be evaluated before selecting an approach.

11 - Change Lifetime Limit On Reduced Tax For Small Business Stock

There are currently a smaller number of potential angels in the marketplace than in the prior 2 decades, as a result of the bursting bubble of 2001-2003. These remaining angels have the potential to be serial angels that invest large sums and keep the small business engine of growth going in the US. Most angel investors lose their investments in technological startups. That is the nature of technological startups and will likely remain that way. However, the lure of a home run success motivates some angels to continue investing.

The tax laws should not discourage potential angel investors from making investments that have a low chance of success. To encourage ongoing participation by this pool of angel investors, it would be best to set a \$10M limit on gains excluded and the lookback period for gains excluded should be reduced to a rolling 3-year lookback period. This would allow successful angels to participate in perpetuity.

12 - Create Sarbanes-Oxley and Similar Rules Exemptions for Microcap Public Companies

Businesses that meet requirements of less than \$80M in total assets and under \$80M in annual revenue should be exempt from some or all of the Sarbanes-Oxley (SARBOX) and similar reporting regulations. No matter how small a business may be, experts in legal and accounting practices indicate that Sarbanes-Oxley costs the smallest of public companies between \$1 million and \$2 million dollars per year and the big 4 accounting firms may charge substantially more as a minimum. On top of Sarbanes-Oxley there are other regulations created in attempts to prevent another Enron or Worldcom disaster that are hitting all companies. These regulations are stifling the engine of growth for the US.

This Sarbanes-Oxley qualification is a hidden tax on small public companies. It has caused many small public companies that had been profitable prior to Sarbanes-Oxley to lose money. This money is going to accounting and legal firms that are not using that extra revenue to create new products and services that grow US wealth and exports.

Sarbanes-Oxley indirectly hurts new startups since it reduces the opportunity for future IPOs and delays M&As. With that extra cost of one to two million dollars per year, the potential for a startup to complete a successful IPO is greatly decreased. Without full Sarbanes-Oxley certification of a small business by a big 4 firm, many large enterprises will not consider an acquisition of a startup. This limits merger and

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acquisition exits for these startups or at best reduces their merger and acquisition valuation. A result from these lesser exit conditions has caused a large portion of venture capital funding to shift to later stage companies.

Those VC firms are forced to finance very late stage companies for many years longer than VC did in the early 1990s and 1980s. VC firms are continuing to finance growing portfolio companies until they are sufficiently large to absorb the cost of Sarbanes-Oxley and still show a high return-on-sales.

Exits have become problematic for all venture funds and are likely to remain problematic for the indefinite future. M&A transactions involving startups are taking place but at pricing levels using similar metrics to large corporate mergers. With these metrics in place the extra burden of Sarbanes-Oxley on those metrics for small companies makes the return to investors (IRR) much lower than suitable given the risk. As a result, early stage investment is running at a lower percentage of VC total investment than at any time over the past decade and longer.

California Specific Changes

C1 Provide Tax Credit for Individual Investors in California Private Companies

Issue: There is a need for larger angel investments in startups that may require 5 or more years to reach an IPO or other exit. This need is especially for most high potential startups in areas such as nanotechnology, alternative energy, biotechnology and semiconductors where exits typically require 7 to 9 years after the initial investment.

Solution: Provide California tax credits of 30% for individual investors on newly issued startup stock in privately held companies that is held for 4 years and increase the tax credit to 50% on startup stock that is held for 8 years or more. This tax credit should include investments in venture funds of \$100M or less that invest a majority of their capital in technological based startups that have fewer than 35 employees and less than \$10 million in assets.

C2 - Provide Tax Credits To California Businesses For California Investments

California has one of the highest costs of doing business of all 50 states. On top of that, high cost other states are poaching California businesses, especially startups, by offering tax incentives such as tax credits, tax holidays and other benefits. Startups in particular have been and continue to be the source of incremental jobs, economic growth and nearly all the growth in tax revenues for California. It is essential to the future economic health of California that new technology and life science startup businesses locate in California and expand their operations in California. An R&D tax credit and a capital investment tax credit for investments made in California operations would provide an incentive to counter offerings from other states. Longer term these tax credits will help keep businesses in California that may otherwise migrate to China and India.

C3 - Expand Science And Math Education For California

Ideally science and math education should be a core curriculum along with reading and writing for all students in the K-12 classroom. Without those core capabilities the other parts of education can be wasted. Many students may not enter the sciences as a profession but still need that science education. A substantial understanding of science is becoming more and more important to every individual to make informed decisions about each person's own health care. Science understanding is also critical regarding decisions about each of our families in terms of safer places to live and work as well as key issues regarding personal transportation and consumption. A strong science education can cause changes in a wide range of individual choices. Those changes can save individuals and the state of California large outlays per capita in the future. Ideally each K-12 student should have classroom time consisting of 2

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hours of science (with half of that in a well-equipped laboratory) and one hour of math education per day for their entire K-12 tenure. This would be in line with other countries that are building economies that will compete with the US in the coming decades. As a start 1 hour of science and 1 hour of math should be instituted as soon as practical.

Along with the classroom time it is important to have skilled and motivated science teachers. Each science teacher should have at least a BS degree in the area of science that they teach with a strong preference for an MS degree. Ideally these science teachers should have some industry experience to bring real world issues to the classroom and make the students become excited about science. There are many possible solutions to developing this science teacher cadre and all will have some price tag. To make the program affordable to California will require creative solutions. One solution that can help would couple mid-career re-education training of engineers and scientists using loans and fellowships to loan forgiveness after a period of teaching in K-12. Many other programs may also be needed to fill the science and math positions that will be needed to cover the added classroom time in K-12. Programs with industry that lend scientists to school districts for a year or so, and providing tax credits to companies that lend scientists providing skilled teaching is another possible approach.

C4 - Exempt Selected Capital Assets From Sales Tax

Many states in the US are inducing companies, even companies based in California, to set up operations in those states to allow companies to expand at a lower cost. This is especially important for small business where cash is both limited and expensive to finance. However, it also applies to larger companies, such as semiconductor companies, that require billions of dollars of equipment.

Going forward the high growth areas for California will be in biotech, nanotechnology, crossover technologies between sciences and similar fields that require expensive hardware for research and development as well as for production. California should strive to keep these companies inside the state. These companies not only employ workers in their plants but on average cause suppliers to employ several times as many workers nearby those plants. The total benefit to the state from an advanced technological plant is on average better than any other activity of similar size. Therefore California should provide the highest incentives to these types of plants.

C5 - Conform California Tax Regulations and Accounting to Federal Regulations

Conform California laws on tax treatment regarding small businesses to federal law, at least for small businesses with revenues and assets under \$50M. A single set of rules and regulations relating to tax and accounting can reduce costs for those companies that are creating the most new jobs. The added costs of tax and accounting are negatives for this type of company and only hinder its growth and employment potential. The goal is to make California, as startup-friendly as the best of other states and recent rankings should California is not doing well on nearly every cost related area. Conformance to federal programs also simplifies accounting and allows startups to spend more money on developing their business by spending less on paperwork.

The added costs and complexity of independent tax regulations such as depreciation equipment make California less attractive to startups in technologies and markets with high potential to create thousands of jobs. These startups are in complex fields such as nanotechnology that has high capital equipment needs for many types of equipment and assets. Adding California's own complexity to an already complex federal system seems excessive to entrepreneurs. In the past many entrepreneurs from other states and countries moved to California to form their startups. With improved communications and transportation it is practical to have a startup outside California and avoid accounting and paperwork complexity.

C6 - Conform California Environmental Protection Regulations To Match Federal

Conform California EPA and other regulations to match US federal regulations for businesses with revenues and assets under \$20m per year that have been in operation for less than 10 years. Allow small

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businesses the chance to become large businesses by simplifying the number of regulations that must be followed until a business either becomes large or becomes stable. These exemptions may not apply to certain traditional businesses that must handle large quantities of selected hazardous materials such as gas stations, dry cleaners, etc.

It is also important to reduce or at least standardize municipal and county environmental regulations and reporting requirements to prevent added layers of complexity and reporting top of federal and state requirements. While we desire a clean environment there are a rare few small businesses that would risk their future and their own health with unsafe practices. A simple combined federal, state, county and municipal regulatory system should be practical. Why should California drive business out of California?

C7 - Reduce California State Regulatory and Filing Requirements

Exempt small technology businesses with assets under \$10M from many California state, county and municipal filing and regulatory requirements. A simple combined federal, state, county and municipal reporting system should be practical. Current complex regulation and reporting is a hidden tax on the small businesses that are the engine of job growth in California. Exempting certain small businesses with assets under \$10M and less than 35 employees should not create any undue risks to employees of selected businesses. A peer review process consisting of a mix of state university professors, investors and entrepreneurs should handle the selection process for exemption. Certain business types should not be exempted, such as gas stations, dry-cleaners and other establishments that have higher levels of risks. Peer review should be sufficient to make intelligent selections.