State Notes

TOPICS OF LEGISLATIVE INTEREST

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Michigan Early Stage Venture Capital Tax Vouchers
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The Senate Fiscal Agency's December 2014 *Economic Outlook and Budget Review* presented projected balance sheets for the General Fund and School Aid Fund for the current 2014-15 fiscal year (FY) as well as FY 2015-16. Both balance sheets contained a new entry, not included in the balance sheets published after the May 2014 Consensus Revenue Estimating Conference, lowering both General Fund and School Aid Fund revenue. This new entry reflects the likely redemption of tax vouchers issued under the Michigan Early Stage Venture Capital program.

The Michigan Early Stage Venture Investment Act was enacted in 2003 in order to, as the legislation states, "promote the economic health" of Michigan by "assisting in the creation of new jobs, new businesses, and new industries". Venture capital is a term that describes money invested in startup firms and small businesses that are perceived to have long-term growth potential but do not have access, or sufficient access, to capital markets. Venture capital investments are often regarded as risky but have the potential to generate above-average returns, at least over a long period of time. As a result, such investments are made only by firms and individuals who have the resources to weather substantial losses or can afford to wait sometimes decades for a return on their money.

Access to capital also can affect location decisions and it is not uncommon for firms that would be likely to attract the attention of venture capital investors to relocate to places where such capital is more readily available. By increasing the amount of venture capital available to Michigan businesses, the Michigan Early Stage Venture Investment Act intended not only to expand Michigan's economy but also to prevent the relocation of promising startup companies already located in the State.

However, in 2003 the State faced serious budgetary constraints because of the weak recovery following the 2001 recession, making it difficult to find funding for a new program that would require significant State revenue. As a result, the Michigan Early Stage Venture Investment Act was designed to commit future State revenue, through the use of tax incentives that would be redeemed in future years when the economy (and presumably State revenue) would be better, to guarantee loans that could invest in venture funds in the near term. Further, the operations of the program were structured to require the involvement of outside venture capital funds, thus allowing the State's near-term investments to leverage additional venture capital from private investors.

This article will provide background information regarding the program established by the Michigan Early Stage Venture Investment Act of 2003, discuss how the program works, describe the impact the program is expected to have on the budget over the next few fiscal years, and suggest options to alter that impact.

Background

In the early 2000s, the Michigan Treasury, the Michigan Legislature, the newly formed Michigan Venture Capital Association, and various individuals began working to create a vehicle to support the emerging venture community and foster greater early stage technology investment. In a bipartisan effort led by legislators and supported by the State Treasurer, the Michigan Early Stage Venture Investment Act of 2003 was enacted. The initial legislation consisted of three measures: Public Acts 295, 296, and 297 of 2003. Public Act (P.A.) 295 and P.A. 297 provided tax credits against the income tax and Single Business Tax (SBT), respectively, for investments made pursuant to P.A. 296. Public Act 296, the Michigan Early Stage Venture Investment Act of 2003, established the corporate and administrative framework for the investments.

As part of the package implementing the Michigan Early Stage Venture Investment Act of 2003, P.A. 297 of 2003 amended the Single Business Tax Act to provide $150.0 million of refundable SBT credits to collateralize (secure loans to) the Venture Michigan Fund (VMF or the Program). The Venture Michigan Fund is a nonprofit corporation created under the Michigan Early Stage Venture Investment Act (the Michigan Early Stage Venture Investment Corporation) and overseen by a seven-member board that includes the State Treasurer and the chief executive officer of the Michigan Economic Development Corporation (MEDC), or their designees, and five other individuals appointed by the Governor, including one from recommendations made by the House, the Senate, and a statewide nonprofit organization representing more than 50% of Michigan venture capital companies (currently the Michigan Venture Capital Association). The loan proceeds were to be used by the VMF to fund investments in venture capital funds operating in Michigan. The legislation indicates that the tax credits would cover any difference between an agreed-upon rate of return for, or negotiated payment to, lenders and the actual return or payment made under the loan agreements. The credits could be redeemed for tax liabilities generated in tax years after 2008 and before 2020. As originally enacted, not more than $30.0 million of credits could be authorized in any calendar year. Public Act 295 of 2003, which amended the Income Tax Act, provided that for tax years after 2009, if a credit could not be claimed against the SBT, it could be applied against income tax withholding requirements and/or transferred to another taxpayer.

In 2005, the program created by the Michigan Early Stage Venture Investment Act of 2003 was revised and expanded. A package of bills was enacted to obtain funds for economic development programs, in relation to the securitization of a portion of tobacco settlement revenue. One of those measures, P.A. 233 of 2005, amended the SBT Act to convert the refundable credits into nonrefundable, but transferable, vouchers, and increase the maximum amount of vouchers that could be issued from $150.0 million to $600.0 million if securitization occurred, as it did. The conversion to vouchers took place because it had been determined that the credits were equivalent to a guarantee and thus deemed unconstitutional.

Under the 2005 legislation, a tax voucher would be a certificate that a taxpayer could remit in lieu of a tax payment or portion of a tax payment, and the voucher would satisfy the taxpayer's associated liability. Vouchers were not to be approved after December 31, 2015, and the amount approved for any tax year was limited to 25.0% of the value of all approved vouchers. The Act retained the requirement that vouchers not be applied before 2009, but further limited the vouchers to be the least of: 1) the amount stated on the voucher, 2) the amount authorized to be used, or 3) the taxpayer's liability. Excess voucher amounts could be carried forward indefinitely. In 2007, with the adoption of the Michigan Business Tax (MBT), the existing legislative provisions were adapted to allow vouchers to be applied against the MBT or income tax withholding.

The Venture Michigan Fund is authorized to promote Michigan's economic health by assisting in the creation of new jobs, new businesses, and new industries in Michigan through the creation of a fund-of-funds that would invest with venture capital managers (private venture capital funds) that, in turn, would invest in Michigan-based early stage companies. Two fund-of-funds were created: the Venture Michigan Fund I, Limited Partnership (VMF I) and the Venture Michigan Fund II, Limited Partnership (VMF II). Both VMF I and VMF II were funded with money borrowed by the Venture Michigan Fund.

The Venture Michigan Fund and Tax Vouchers

As permitted by the Michigan Early Stage Venture Investment Act, the State Treasurer has approved $450.0 million in vouchers that may be issued by the VMF, with $200.0 million in vouchers allocated to VMF I and the remaining $250.0 million to VMF II. For both VMF I and VMF II, the Venture Michigan Fund borrowed money to invest with venture capital funds. The loan agreements specified the amount of the loan, the timing over which funds from the loan could be drawn down, the timing and amounts for repayment of principal and interest, and the establishment of reserve funds to pay debt service, operate the funds, and allow required capital contributions to venture capital funds. Both the reserve funds and the tax vouchers serve as collateral for the lenders that provided the loans. According to the Administration, the tax vouchers were designed to serve as collateral for the loans and at least a portion of the vouchers was always intended to be used to repay some portion of the loans. Although copies of the agreements are submitted to the Department of Treasury, the VMF's activities, including any borrowing terms and investment plans, are overseen by the VMF's board of directors.

The amount and timing of tax voucher use are affected by several factors, including the performance of the venture capital funds, the timing of cash flows to and from the venture capital funds, and the discount to face value at which the vouchers are sold. The vouchers represent the primary source of collateral for the lenders' loan underwriting and were considered critical because the VMF possessed no assets of its own to collateralize any debt.

The legislation places no restrictions or other requirements on the agreements, and a limited number of restrictions on any investments made by the VMF. However, investments were supposed to be made in venture capital funds that would, in turn, invest in companies that would be the most successful at generating above-average returns in the context of pursuing a variety of economic development priorities. Investments from VMF I and VMF II in a venture capital fund were not to exceed 25.0% of a recipient's capital, and recipients were to have a substantial Michigan presence.

Section 27 of the Early Stage Venture Investment Act of 2003 requires the VMF to publish annual reports that include information regarding all activities, an analysis of the economic impact of its investment plan, the number of jobs represented by investments, and a variety of detail on the return on any investments. However, the law does not require these annual reports to be submitted to any specified entity. While both the audited annual financial reports and the annual reports required under Section 27 have been produced, and provided to the Department of Treasury and the Michigan Economic Development Corporation, the Senate Fiscal Agency (SFA) has been unable to obtain copies.

VMF I and VMF II

As noted earlier, the Venture Michigan Fund currently has two main investment programs operating: VMF I and VMF II. Both operate in substantively the same manner but represent two discrete investment operations. The first major activities under VMF I began in 2006, when VMF I secured $200.0 million in loans from special purpose entities formed by Deutsche Bank and Credit Suisse. The loans were drawn down in five equal annual installments and were collateralized by $200.0 million in tax vouchers, with portions of the loan proceeds allocated to reserves required under the loan agreements. The loans bear a fixed interest rate of 6.875% and repayment of principal will occur over a 50-month period scheduled to begin in June 2015. After the deductions for the required reserves, the VMF committed $95.0 million to the VMF I program.

Operational activities for VMF I and VMF II are handled by a fund manager that the Venture Michigan Fund contracts with to manage the programs. The fund manager uses VMF's capital commitments to make capital commitments to venture capital funds. These venture capital funds then use the VMF commitments, and commitments from other investors, to make investments in early-stage Michigan companies meeting the criteria identified in the Early Stage Venture Investment Act. As a result, venture capital firms essentially pool money from a variety of investors, not just from VMF I, and then select what they perceive as promising investments in early-stage Michigan businesses. Therefore, the funds from VMF I generally will represent only a portion of both the money invested in a venture capital firm and the venture capital firm's underlying portfolio of investments in firms. VMF I has committed to invest $95.0 million with 11 venture capital funds, some based and/or located in Michigan and some based/located in other states.

Figure 1 illustrates the cash flows involved in the process when VMF I began operations. The process began with the State authorizing the VMF and the tax vouchers. After the lenders became involved, there are actually two "circles" of money flowing, joined by the link between the lenders and the VMF. One circle is the tax vouchers, which are discussed in more detail later. These vouchers flow from the State to the lender to various taxpayers and are ultimately redeemed by the State. The second circle involves the proceeds from the loan. This circle, discussed in more detail below, involves the VMF investing the loan proceeds in venture capital funds, which in turn invested in Michigan early stage businesses. As illustrated by Figure 1, both circles of money flow are rather complex.

If the cash flow details created by the VMF obtaining the loan proceeds over a five-year period are ignored, the loan proceeds of $200.0 million were initially directed to three accounts: an interest reserve, a shortfall reserve, and an operating account. After a 2014 amendment to the financing structure, a capital contribution reserve account also was created.

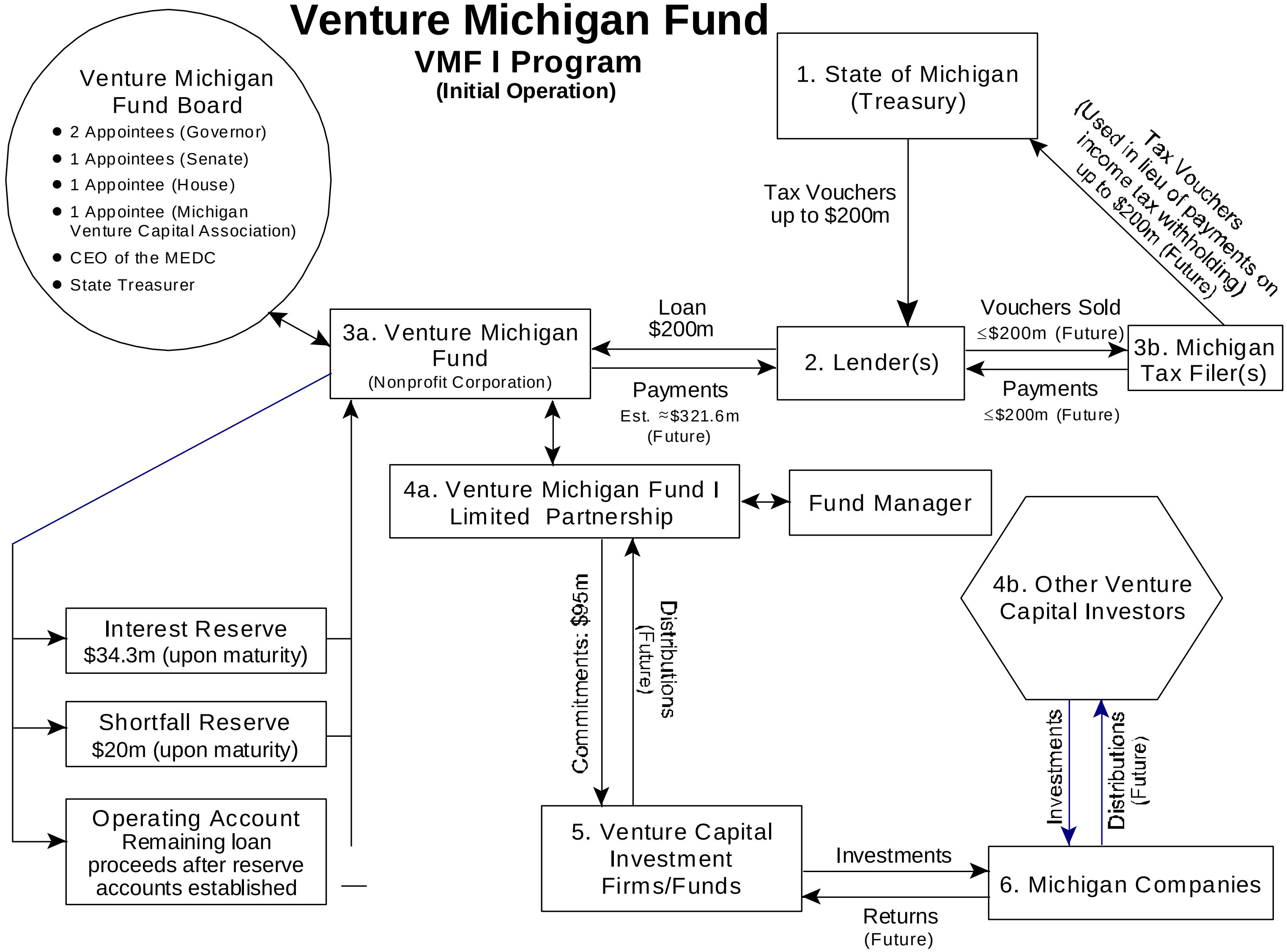
Figure 1 attempts to illustrate two things: 1) the flow of money from various entities and funds, and 2) the magnitude of the various money flows. While the structure of the relationships is relatively straightforward, specific numbers in the figure can be misleading. For example, it is estimated that the shortfall reserve will eventually need to provide $20.0 million in proceeds. However, the demands for money from this account will occur over a period of years and the money in the reserve was invested so that, upon maturity, the account would provide the full $20.0 million, even if at any specific time the account does not exhibit a balance of $20.0 million. Similarly, money was initially deposited in the interest reserve account and invested so that, upon maturity, the account would provide $34.3 million, even if at any specific time the account does not exhibit a balance of $34.3 million. Over the last several years, the operating account has been depleted as capital contributions to the venture capital funds and expenses, particularly interest expenses, were paid from the account's balance. As a result, any monetary amounts shown in Figure 1 represent the value as of a specific point in time.

Figure 1

Venture Michigan Fund

VMF I Program

(Initial Operation)



The interest reserve was initially dedicated to making the interest payments on the loan during the time the loan was expected to be repaid, beginning in June 2015. The money in the account was invested and the securities are configured to have maturity dates and amounts adequate to cover all of the interest due on the loans. The reserve initially invested in securities that would yield $34.0 million upon maturity. However, these securities were offered by AIG and during the 2008-2009 financial crisis the securities were downgraded and deemed insufficient to qualify as a valid reserve investment. As a result, and in order to avoid a default on the loans that would have triggered the use of the tax vouchers, VMF I invested an additional $28.1 million (with a face value at maturity of $34.3 million) as a new interest reserve. The shortfall reserve also held securities issued by AIG. The AIG securities for both the interest reserve and the shortfall reserve were retained until they had appreciated and were sold in December 2012 and January 2013 for approximately $46.2 million, which represented a gain of $3.7 million relative to the value the investments had accumulated as of the sale date. The proceeds from these sales were deposited into the operating account to replace the additional amounts that had been deposited into the interest and shortfall reserves as a result of the downgrade.

The $20.0 million directed to the VMF I shortfall reserve was intended to cover discounts that were expected to occur when the tax vouchers are sold. The vouchers have a face value of $200.0 million. However, because the lenders are not located in Michigan, they are not likely to be able to use the vouchers. (Although the vouchers could be applied to MBT payments, it is expected that the vouchers will likely be applied against individual income tax withholding payments required by the State, and without any employees in Michigan, the lenders would not be subject to any withholding requirements.) Therefore, in order for the vouchers to generate money for the lenders, the lenders will need to sell the vouchers to taxpayers who will have the ability to use them. As a result, the lenders are likely to realize less in proceeds from the sale than the $200.0 million face value of the vouchers. The shortfall reserve is an account intended to cover the difference between the face value of the vouchers and what the lenders ultimately receive when the vouchers are sold. As the size of the reserve suggests, the vouchers were predicted to be purchased at a 10.0% discount, meaning that $50.0 million of vouchers would sell for $45.0 million. However, although the sale would generate only $45.0 million in proceeds for payment to the lender, the full $50.0 million must still be repaid and the purchaser would be able to redeem the vouchers for the full $50.0 million face value, thereby reducing State withholding revenue by $50.0 million.

Proceeds not directed to these reserve accounts were placed into the operating account. As a result, the operating account held proceeds both to fund the VMF I's commitments to venture capital funds and to address virtually all of the other fees and expenses associated with operating VMF I. While $95.0 million of the loan proceeds was committed for investment in venture capital funds, the commitments do not immediately translate into actual investments. The venture capital funds draw on the capital commitments over time as suitable investments are determined and/or need additional capital; until the venture capital funds make such capital calls, the money remains in the operating account. As a result, the operating account's balance has varied, as venture capital funds have drawn down the capital VMF I has committed. Aside from funding VMF I's commitments to the venture capital funds, the greatest expense the operating account has covered has been the roughly $14.0 million in annual interest the loan has generated. Like the other accounts, the operating account also has generated interest income from its balances.

In 2014, the VMF also established a $10.0 million capital contribution reserve account for VMF I to cover capital calls made on the VMF by the venture capital funds in which VMF I had made commitments, as well as to cover operating expenses. This reserve balance is measured and reassessed on a monthly basis, and can have a maximum balance of the lesser of $10.0 million or 90% of VMF I's remaining capital commitments to the venture capital funds. This account was created as a result of amendments to the original loan, which also required any remaining cash in the operating account to be used to repay the loan. Since the 2014 amendment, approximately $4.0 million of the loan principal has been repaid.

Figure 2 illustrates the cash flows and financing structure of VMF I as of December 31, 2014. As a result of both returns from investments and capital freed up by various restructuring in the financing arrangements, approximately $4.0 million of loan principal has been repaid. VMF I has received approximately $14.0 million in distributions from the venture capital funds, which has helped cover ongoing interest and operating costs. VMF I also has paid approximately $84.5 million in interest to the lenders. Once the scheduled repayment process begins in 2015, the voucher sale process will begin, ultimately leading to repayment of the loan principal, and the declining loan principal will result in lower interest payments from VMF I.

VMF II operates functionally the same way as VMF I. The initial loan from an affiliate of Credit Suisse was for $250.0 million, and is being drawn down in six equal annual installments that began in December 2010. The last draw on the loan is scheduled to occur in January 2016. The VMF II program has committed $120.0 million for investment with 10 venture capital investment firms. Some of the funds receiving VMF II are the same funds (or affiliate funds) as those invested in by VMF I.

As of November 2014, the two VMF programs had invested $155.0 million in 42 Michigan early-stage companies. Because the venture capital funds pool these investments with money from other investors, these companies have actually received a total of $879.5 million of investments, suggesting that the Michigan portion of these investments leveraged an additional $724.5 million of investment capital. According to the data received by the SFA, these 42 Michigan companies currently have more than 1,000 employees and employment at these firms has increased by approximately 59.5% since the firms began receiving capital from the VMF program.

In addition to resulting in capital investments in early-stage Michigan companies, the Michigan Early Stage Venture Investment Act of 2003 has affected the venture capital industry in Michigan. The number of venture capital firms headquartered in Michigan has increased from just a few in 2003 to 16 in 2009 and 23 in 2013; the number of venture capital professionals employed at these firms almost doubled in the last five years, rising from 44 in 2009 to 81 in 2013, according to the Michigan Venture Capital Association.

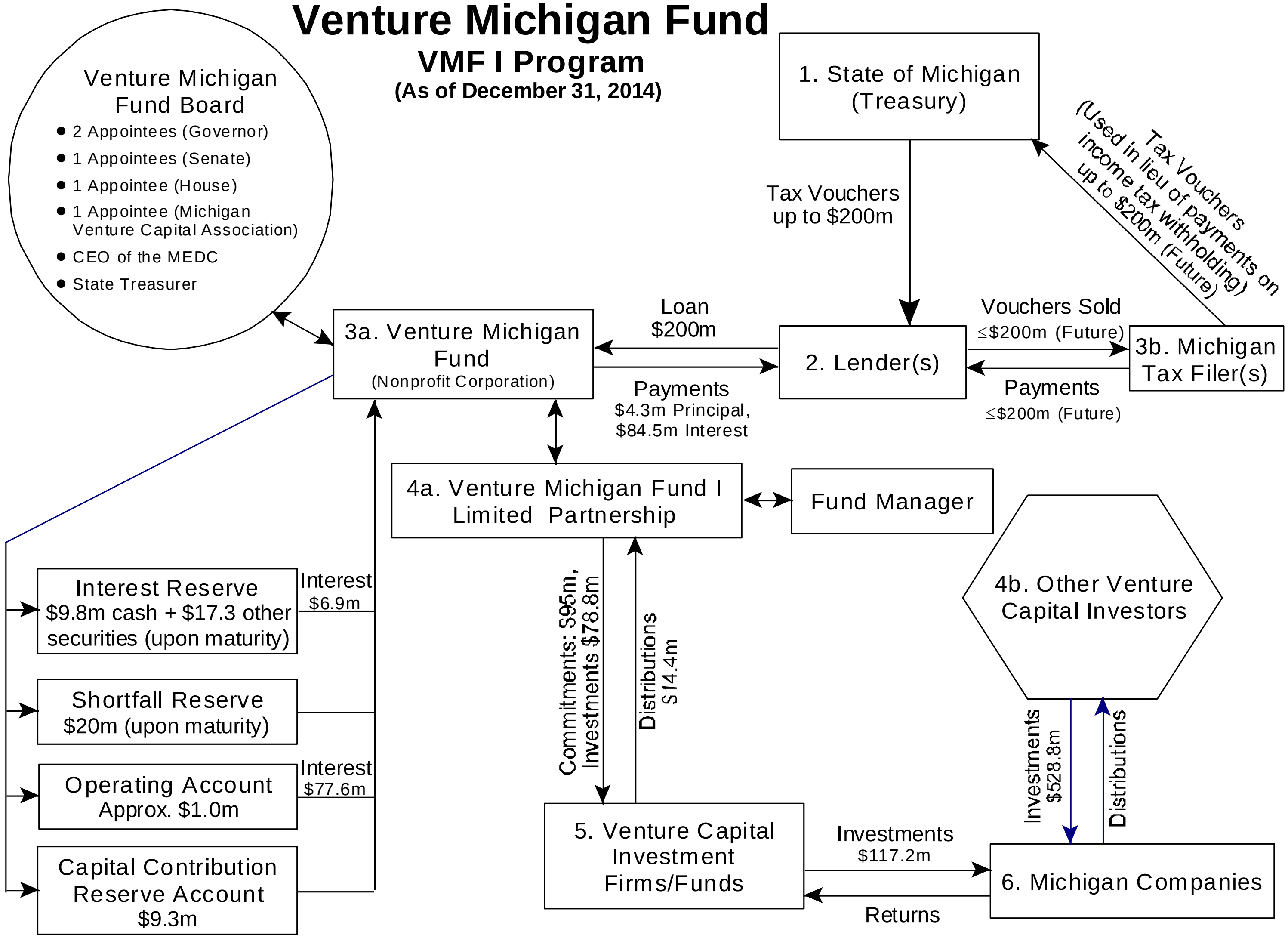
The growth of early-stage companies is often constrained by limited available capital and the business activity is often very capital-intensive. Furthermore, early-stage companies are often characterized by long lead times to product development, resulting in long time horizons for potential investment returns. Realization of these aspects of the investments is illustrated by the enacting legislation, which does not call for the Venture Michigan Fund to expire until January 1, 2054, roughly 50 years after the initial legislation took effect.

Figure 2

Venture Michigan Fund

VMF I Program

(As of December 31, 2014)



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Impact of the Vouchers on State Revenue

As indicated earlier, the tax vouchers are forecasted to be applied against a taxpayer's withholding liabilities under the Michigan individual income tax. Taxpayers will essentially remit a voucher in lieu of a payment or portion of a payment. The redemption amount will reflect the face value of the voucher, not the price a taxpayer may have paid when the taxpayer purchased it from the lender. Withholding revenue is directed to both the General Fund and the School Aid Fund, with the School Aid Fund receiving approximately 23.8% of the revenue. Any portion of the vouchers applied against MBT liabilities would reduce only General Fund revenue.

The loan agreements provide a schedule for both interest payments and principal repayment. The necessity and timing of selling tax vouchers to meet the terms of the repayment schedule depends on the timing and amount of any returns generated by the investments in the venture capital funds. Based on current information, vouchers worth $140.0 million are currently scheduled to be sold, and will be presented to the lenders as follows:

1) $25.0 million in June 2015.
2) $25.0 million in October 2015.
3) $50.0 million later in FY 2015-16.
4) $40.0 million in FY 2016-17.

While this schedule indicates when the lenders will receive the vouchers, it does not indicate when the vouchers will be sold by the lenders, what proceeds the lenders will ultimately receive for the vouchers, or when a buyer will use the voucher to satisfy a tax obligation. As a result, the fiscal impact of the vouchers may or may not occur during the fiscal year in which the vouchers are presented to the lenders.

Assuming the first two redemptions post against FY 2014-15 individual income tax withholding revenue and the rest post in the fiscal year in which they are presented to the lenders, the vouchers will reduce General Fund revenue by $38.1 million in both FY 2014-15 and FY 2015-16, and by $30.5 million in FY 2016-17. Over the life of the vouchers, assuming all $450.0 million in vouchers is ultimately used, the entire General Fund reduction could total as much as $342.8 million. Similarly, based on the same assumptions, the redemptions will reduce School Aid Fund revenue by $11.9 million in both FY 2014-15 and FY 2015-16, by $9.5 million in FY 2016-17, and over the life of the vouchers by as much as $107.2 million.

Options to Alter the Fiscal Impact of the Vouchers

The State has limited options available to alter the fiscal impact of the vouchers on State revenue, primarily because the money for the VMF programs has largely already been borrowed. As a result, the State's maximum liabilities related to the program are essentially fixed at $450.0 million. However, the Legislature could make changes to the Program that could alter the timing and/or magnitude of the impact, as well as the distribution of the impact between the General Fund and the School Aid Fund.

The most extreme option the State could pursue would be to terminate the Venture Michigan Fund Program. Such a termination would result in a default under the loan documents for both VMF I and VMF II, with the potential of affecting the State's reputation in capital markets. Furthermore, the interest rate on the loans would increase until both loans were repaid and would allow the lenders to accelerate their sale of all tax vouchers. Not only would the vouchers be sold more rapidly, accelerating the impact of revenue losses to the State, but the volume of vouchers would likely increase for two reasons. First, because the investments for VMF I and VMF II are also collateral for the lenders, the lenders would liquidate those investments in the venture capital funds, and these sales would likely face steep discounts because these investments have not yet matured to their maximum value. Second, the sale of such a large volume of vouchers might increase the discount applied to the voucher sales and thus increase the number of vouchers that would need to be sold in order to generate sufficient proceeds to repay the loans. The most significant drawback to this approach is that the State's liabilities would be relatively unchanged: the $450.0 million in loans still would need to be repaid and the $450.0 million in vouchers would still need to be honored. The only potential savings would occur if the losses on the current investments were less than the net interest paid on the loans; and, if the calculation includes the net return on the investments that would be generated if the programs were not terminated, the likelihood of savings is further reduced. Furthermore, unlike VMF I, the VMF II program is sufficiently new that the prepayment penalties on the loan used to fund VMF II have not yet expired, meaning that an early payoff of the loan would have additional costs beyond the outstanding balance.

Another option involves limiting the amount of vouchers that can be redeemed each fiscal year. The timing of when the vouchers need to be sold is largely driven by when returns are received from the investments and the repayment schedule for the principal. Assuming the returns in the short term are unlikely to generate sufficient revenue for repayment, the repayment schedule is essentially the same as the one for voucher sales. However, while voucher sales generate proceeds for the lenders according to the repayment schedule, no similar requirement exists for the taxpayers that purchase the vouchers. As a result, the State could limit the total amount of vouchers that can be redeemed each fiscal year, either on a per-taxpayer basis or in total for all taxpayers, or both. Such limitations could reduce the amount of revenue the State would lose each year and would be somewhat consistent with the original tax credit legislation that limited the credits to not more than $30.0 million per year. However, limiting the potential ability of taxpayers to redeem vouchers would likely increase the discount associated with their sale, thus increasing the use of vouchers over time and resulting in a greater loss of revenue to the State. Depending on the degree to which discounts were affected, such changes also would have the potential to raise default issues under the loan agreements.

A third option, one that would not require any legislation other than an appropriation, or raise issues of default under the loan agreements, would be for the State to purchase the vouchers from the lenders at face value. Under such an arrangement, the State could save money because no discount would need to be built into the voucher sale and greater proceeds would be available to repay the loans. As indicated above, the agreement structure assumes a 10.0% discount on the sale of the vouchers, so a $50.0 million voucher sale would reduce State revenue by $50.0 million but generate only $45.0 million for the lender. In this example, the State's purchase of $50.0 million in vouchers from the lender would reduce State revenue by $50.0 million but generate $50.0 million in proceeds for the lender, rather than only $45.0 million. Given that the sale of vouchers would generate higher proceeds, fewer vouchers would likely need to be sold in aggregate. Furthermore, this option could reduce the costs to the State because the VMF could attempt to negotiate more favorable terms with the lenders. One additional facet of this approach is that it would eliminate the impact of the vouchers on the School Aid Fund, and all of the impact would fall on the General Fund because General Fund revenue would be used to purchase the vouchers.

Conclusion

Because of the risks associated with early-stage businesses, venture capital finance is complicated and requires investors to accept long time horizons in order to maximize returns. The Michigan Early Stage Venture Investment Act of 2003 not only had to contend with the complexities of venture capital markets but needed to address the problem of how the State, during a recession and accompanying budget difficulties, could encourage such businesses in an effort to create, as described in the Act, "new jobs, new businesses and new industries within" Michigan. More than a decade later, the costs associated with that endeavor are coming due. How those costs will be addressed is something that will likely be determined during the 2015-2016 legislative session.