State Notes

TOPICS OF LEGISLATIVE INTEREST

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Update on the Michigan Early Stage Venture Capital Tax Vouchers
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Michigan enacted the Michigan Early Stage Venture Investment Act in 2003 in order to provide a mechanism to increase the level of early stage technology investment in Michigan. Under the Act, in basic terms, the State issued tax vouchers that would reduce future tax payments. The vouchers guaranteed repayment of bank loans, whose proceeds were distributed to venture capital firms to invest in early stage companies. The vouchers were not redeemable until several years after the loans were made. The vouchers guaranteed that lenders would receive payments on a timely basis, in case the return from the investments did not yield sufficient revenue to repay the loans. Two waves of borrowing and investments, totaling $450.0 million, were implemented by the Venture Michigan Fund (VMF) Corporation created by the Act, referred to as VMF1 (for $200.0 million) and VMF2 (for $250.0 million). Many of the details of the program were discussed in the Senate Fiscal Agency's Winter 2015 issue of *State Notes*.

The vouchers are redeemable against the Michigan Business Tax or Michigan's withholding requirements under the individual income tax. It has been anticipated that outstanding vouchers will overwhelmingly be redeemed against individual income tax withholding requirements, meaning that any revenue impact will affect both the General Fund and the School Aid Fund (SAF). The first vouchers were scheduled to be redeemed in June 2015, for $25.0 million. Another $25.0 million redemption was scheduled for October 2015, while an additional $50.0 million redemption was expected during fiscal year (FY) 2015-16. The State instead chose to purchase the vouchers at face value, with the first purchase occurring on July 1, 2015. The purchases, $50.0 million of which affected FY 2014-15 expenditures (with the other $50.0 million affecting FY 2015-16 expenditures), saved the State money by ensuring that a greater portion of the voucher redemption amount was applied to the loan principal and by paying some of the vouchers earlier. The purchase, made from General Fund revenue, also eliminated the risk of the vouchers having any impact on SAF revenue. All of the vouchers associated with the purchase had been issued in relation to VMF1.

Based on the terms of the loan agreement, additional payments on VMF1 of $20.0 million were due on March 31, 2017, and June 30, 2017, totaling $40.0 million. Another $10.0 million would have been due during FY 2017-18, and the residual during FY 2018-19. Because of the savings associated with the prior voucher purchases, only $88.5 million of loan principal remained outstanding as of October 2016, although the principal was backed by $100.0 million of vouchers. The appropriation bills initially enacted for the FY 2016-17 budget accounted for the $40.0 million impact of the voucher redemptions on State revenue, but did not appropriate any money to purchase the vouchers directly, as had been done in FY 2014-15 and FY 2015-16.

If the State were to purchase additional vouchers directly, policy-makers needed to decide whether to purchase only the vouchers expected to be redeemed during FY 2016-17, or to also include additional redemptions expected during FY 2017-18 or later fiscal years--up to and including paying off the remaining balance and eliminating the impact of any voucher redemptions associated with VMF1. Table 1 outlines the recent history of voucher purchases for the VMF1 program, and shows the impact of four different options that could have been taken for FY 2016-17: 1) letting the vouchers be redeemed, 2) purchasing $40.0 million of vouchers in FY 2016-17, 3) purchasing $50.0 million of vouchers during FY 2016-17, or 4) paying off the remaining VMF1 balance during FY 2016-17 (the approach ultimately taken). Each decision would have had not only an impact on the FY 2016-17 budget, but implications for future fiscal years, as well. Similarly, any of the last three decisions would have altered the impact across funds--resulting in the General Fund bearing a greater share (or all) of the cost of VMF1 obligations and reducing (or eliminating) the impact on the School Aid Fund.

Table 1

Tax Voucher Transactions for Venture Michigan Fund I*
(amounts in millions)

Fiscal Year	Voucher Options	Voucher Purchase/Redemption Amounts	Remaining Outstanding Vouchers	Remaining Loan Principal
FY 2014-15		$50.0	$150.0	~$145.0
FY 2015-16		$50.0	$100.0	$88.5
FY 2016-17	#1) Redemption	$40.0	$60.0	~$53.5
	#2) Purchase $40m	$40.0	$60.0	~$47.1 ($32.7 payoff)
	#3) Purchase $50m	$50.0	$50.0	~$36.9 ($22.5 payoff)
	#4) Full Payoff	$71.7	$0.0	$0.0
FY 2017-18	Under options #1 & #2	$10.0	$50.0	~$37.1 to ~$44.5
FY 2018-19	Under options #1- #3	~$37.1 to ~$44.5	$0.0	$0.0

*Note: Only includes transactions related to Venture Michigan Fund I. Total vouchers issued were $450.0 million: $200.0 million for VMF1 and $250.0 million for VMF2.

If the State had pursued option 1, the $40.0 million of vouchers coming due during FY 2016-17 would have been redeemed, lowering General Fund revenue by $30.5 million and the SAF by $9.5 million. As indicated in the previous *State Notes* article regarding the Venture Michigan Fund, while revenue to the State would have fallen by $40.0 million, because the vouchers are sold at a discount, the outstanding balance on the VMF1 loan would have fallen by less than $40.0 million.

Alternatively, as in 2015, the State had the option to purchase all or some of the remaining vouchers and thereby lower the net impact on the State. Under option 2, the State would have purchased the $40.0 million of vouchers that would come due during FY 2016-17, converting the $9.5 million SAF revenue impact into a General Fund impact and allowing a greater portion of the fiscal impact to be applied to the principal. Option 3 would have done everything as under option 2, but also would have accelerated the repayment of the $10.0 million in vouchers due during FY 2017-18, bringing the total General Fund cost to $50.0 million in FY 2016-17. Finally, under option 4, because full repayment of the outstanding principal would release certain money held in reserve and shortfall accounts, the State would have spent approximately $71.7 million and actually paid off the remaining VMF1 balance during January 2017. Pursuing option 2, 3, or 4 would have required a supplemental appropriation.

A summary of these options is shown in Table 1. In the options under which purchases could occur, the revised loan payoff amounts are also indicated. For example, if the State had pursued option 2, $60.0 million of vouchers would have remained outstanding, the remaining loan balance would have been approximately $47.1 million, but the payoff amount would have been lowered to approximately $32.7 million. Furthermore, the State would have still needed to make a $10.0 million payment in FY 2017-18. Similarly, if option 3 had been pursued, the loan balance would have declined to approximately $36.9 million and the payoff amount would have been lowered to approximately $22.5 million.

Public Act 340 of 2016 (Senate Bill 800 of 2016) appropriated $72,034,000 not only to directly purchase the vouchers scheduled to be redeemed during FY 2016-17, but also to pay off the outstanding VMF1 balance and eliminate all remaining vouchers backing the VMF1 liability. The $72.0 million appropriation included extra funds to make sure that the appropriation would cover any interest charges that might accrue given that the exact pay-off date was uncertain. The actual payoff amount ultimately totaled $71.7 million, allowing approximately $317,000 of the appropriation to lapse to the General Fund and forgoing the need to tap into an associated $1.5 million contingency appropriation.

Any option other than the $71.7 million payoff, while spreading payments across a longer period of time, would have ultimately cost the State more because the unpaid balance would have continued to accrue interest. It should be noted that the $71.7 million payoff affected only the obligations under VMF1. The purchase does not have any significant impact on obligations due under VMF2. Voucher redemptions under VMF2, which currently total $250.0 million, are scheduled to commence in FY 2019-20.

Between the purchases in 2015 and 2017, the State saved significant money by purchasing the vouchers directly. A total of $200.0 million in vouchers was issued to back the loans under VMF1, and in the end, the purchases cost the State $171.7 million. As a result, the State saved a total of $28.3 million. Furthermore, the purchases changed the incidence of the vouchers between funds. The purchases allowed the General Fund to bear the entire cost of the $171.7 million; if the vouchers had ultimately been redeemed, it would have lowered General Fund revenue by $152.4 million and School Aid Fund revenue by $47.6 million.