Senate Research Office

AT ISSUE

CAPCOs: A New Approach to Attract Venture Capital to Georgia

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December 2011

Background: State-Sponsored Venture Capital Programs

State-sponsored and assisted venture capital programs have been in existence since the late 1970s, with early programs established in Massachusetts, Kansas, and Connecticut. However, the success of these programs has been mixed. In some states, public venture capital programs were criticized for various reasons, including: inadequate public funding, lack of needed expertise in fund management, perception of political interference in investment decisions, government regulations that impeded fund operations, and poor financial return on fund investments.

Concerns with previous state-sponsored venture capital programs, changes in the fiscal and political environments, and the increasing number of technology-based startup companies in the 1990s encouraged several states to establish Certified Capital Company programs (CAPCOs) as an alternative for increasing the supply of venture capital in states that traditionally did not receive much venture capital.

The first CAPCO legislation was passed in Louisiana in 1983, with subsequent adoptions during the height of the dot-com boom in the 1990s. By 2005, Georgia, Missouri, New York, Wisconsin, Florida, Alabama, Colorado, Texas, and Washington D.C. all enacted similar legislation. Although Georgia's CAPCO law was later repealed when the recession early in the last decade resulted in investors unwilling to invest in technology-startups and a lack of State funding, the General Assembly is now, once again, considering resurrecting a similar program.

Current Georgia CAPCO Legislation

Under House Bill 298 (House Committee Substitute) and Senate Bill 203 (House Floor Substitute), CAPCOs are state-certified venture capital companies funded by insurance companies. As an incentive to invest in CAPCOs, insurance companies receive a specific credit, usually a $1 credit, on premium taxes for each $1 invested (the tax credits are spread out over five years). The aggregate amount of investment tax credits to be allocated to all participating insurers must not exceed $125,000,000.

With the money from insurance companies, CAPCOs act as venture capitalists, investing in small businesses and startups either by lending them money or buying stock in them according to an established time schedule to ensure the availability of tax credits to the insurance companies. An insurer's return-on-investment is virtually guaranteed as the legislation authorizes the CAPCO to return up to 100 percent of the insurer's initial investment in the form of a distribution. The State does not participate in any form of profit sharing with the CAPCO or insurer.

Critics and Supporters

Supporters of CAPCOs are quick to point out that the program is an effective and quick way to infuse the state with public-sponsored venture capital without having to issue bonds. The infusion of venture capital will then help to attract more startup and small-cap technology-based businesses while also creating highly skilled jobs. The increase in new jobs and new businesses will offset and eventually outweigh any loss of state revenue in the form of tax credits.

Critics point out that it is very difficult to track just how many jobs are being created, that a venture capital infrastructure already exists, and that a state would be better off investing directly through an established venture capital fund just like any other investor. They contend that if a state invests 20 percent of the money, then it should receive 20 percent of the profits. Currently, most CAPCO laws return nothing or very little to the state. So aside from questioning a

CAPCO's effectiveness in creating jobs and generating new tax revenues, critics conclude that any such benefit from CAPCOS would be at least as great if the state invests in a traditional venture capital fund.

	A BREAKDOWN OF GEROGIA'S SENATE BILL 203
Key Terms	**Georgia Small Business Investment Company:** This is the Certified Capital Company or CAPCO and is essentially a Venture Capital enterprise. **Participating Investor:** This is the Insurance Company that contributes its money to the CAPCO for investing purposes. The Insurer will earn a vested credit against its state premium tax liability equal to 100 percent of its investment of designated capital. The credit is spread out over five years at 20 percent per year starting January 1, 2014 through 2018. **Qualified Business:** This is the Georgia small business receiving funding from the CAPCO. Such businesses must not employ more 100 employees. The bill specifically defines which types of businesses are not classified as Qualified Businesses, examples of which include: professional services provided by doctors, accountants, lawyers; banking or lending; real estate development, Insurance; and oil and gas exploration. **Qualified Debt Instrument:** A debt instrument issued by a CAPCO that is issued at par value or a premium; has an original maturity date of at least four years, and a repayment schedule that is not faster than a level principal amortization over four years; and has no interest or payment features that allow for the prepayment of interest or are tied to the profitability of the CAPCO or the success of its investments. **Qualified Distribution:** Basically a distribution or payment by a CAPCO to cover its internal expenses, a 2 percent management fee, or payments of principal and interest to holders of Qualified Debt Instruments. **Qualified Investment:** The investment of money by a CAPCO in a qualified business for the purchase of any debt, security, debt participation, equity, or hybrid security of any nature.
Overseeing Agency	Department of Economic Development
CAPCO Definition	Certified Capital Companies or CAPCOs are referred to as "Georgia Small Business Investment Companies" in the legislation and are essentially Venture Capital enterprises investing in Qualified Businesses. A CAPCO must be a partnership, corporation, trust, or LLC., organized on a for profit basis, that: ▪ Has its principal office located or is headquartered in Georgia; ▪ Has as its primary business activity the investment of cash in qualified businesses; ▪ Has an equity capitalization of $500,000 or more in the form of unencumbered cash, marketable securities, or other liquid assets; ▪ Has at least two principals or persons employed or engaged to manage the funds who each have a minimum of five years of money management experience in the venture capital or small business investment industry; and ▪ Is certified by the Department as meeting the criteria in this legislation.
Total Credit Allocated	The aggregate amount of investment tax credits to be allocated to all participating investors (Insurance Company) of CAPCOs must not exceed $125,000,000 and no CAPCO, on an aggregate basis with its affiliates, may file credit allocation claims that exceed $125,000,000.
Structure of Tax Credit	A participating insurer will earn a vested credit against its state premium tax liability equal to 100 percent of its investment of designated capital in a CAPCO. The credit is spread out over five years at 20 percent per year starting January 1, 2014 through 2018. No Insurer may file an allocation claim for more than 25 percent of the maximum amount of investment tax credits ($31,250,000). The credit for any taxable year must not exceed the state premium tax liability for such year. If the amount of the credit exceeds the state premium tax liability for such year, the excess will be an investment tax credit carryover to future taxable years without limitation.
Who is Eligible for Tax Credit	Any insurance company or other person subject to the premium tax.

Qualified Businesses	Once it receives investment capital from a participating investor, the CAPCO is authorized to invest that capital only in certain kinds of businesses, called "Qualified Businesses" under the bill. A qualified business must meet all of the following requirements: ▪ It is headquartered in Georgia, its principal business operations are located in this state, and at least 60 percent of its employees are located in Georgia; ▪ It has 100 employees or less; ▪ It is not predominantly engaged in: o Professional services provided by accountants, doctors, or lawyers; o Banking or lending; o Real estate development; o Insurance; o Oil and gas exploration; o Direct gambling activities; or o Making loans to or investments in a Georgia small business investment company or an affiliate; and ▪ It is not a franchise of and has no financial relationship with a Georgia small business investment company or any affiliate prior to the investment company's first qualified investment in the business.
Schedule of Investments	Once it receives its investment funds (known as the Allocation Date), a CAPCO must make qualified investments as follows: 1. At least 35 percent of its designated capital within three years or lose certification; 2. At least 50 percent of its designated capital within four years or lose certification; 3. At least 60 percent of its designated capital within five years or it will not be permitted to receive management fees, until such time as it has made such qualified investments; and 4. 100 percent of its designated capital within seven years or it will not be permitted to receive management fees, until such time as it has made such qualified investments. A CAPCO must not invest more than 15 percent of its designated capital in any one qualified business without the specific approval of the Department. Designated capital and proceeds of designated capital returned to a CAPCO after being originally invested in qualified investments may be invested again in qualified investments, and such investment will count toward these requirements.
Share of Distribution or Profit	At anytime, a CAPCO can make a qualified distribution to cover such things as business, legal, or regulatory costs. In addition, a qualified distribution also includes an annual management fee not to exceed 2 percent. In order for a CAPCO to make a distribution (but not a qualified distribution) to its equity holders (Insurance Company), the cumulative amount of all qualified investments of the CAPCO must be equal or exceed 100 percent of its designated capital. The State receives no profit sharing fee from the distribution.
Other Restrictions or Limitations	All designated capital not invested in qualified investments by a CAPCO must be held or invested in such manner as the CAPCO, in its discretion, deems appropriate. Prior to making a proposed qualified investment in a specific business, a CAPCO must request from the Department a written determination that the proposed investment will qualify.

Annual Review Submitted to the State	Every CAPCO must report the following to the Department as soon as practicable after the receipt of designated capital: ▪ The name of each participating investor from which the designated capital was received, including such participating investor's insurance tax identification number; ▪ The amount of each participating investor's investment of designated capital; and ▪ The date on which the designated capital was received. On or before January 31 of each year CAPCOs must report: ▪ The amount of the CAPCO's remaining uninvested designated capital at the end of the immediately preceding taxable year; ▪ Whether or not the CAPCO has invested more than 15 percent of its total designated capital in any one business; ▪ All qualified investments that the CAPCO has made in the previous taxable year, including the number of employees of each qualified business in which it has made investments at the time of such investment and as of December 1 of the preceding taxable year; and ▪ For any qualified business where the CAPCO no longer has an investment, the CAPCO must provide employment figures for that company as of the last day before the investment was terminated. Each CAPCO must also provide an audited financial statement conducted by an independent CPA of itself within 180 days of the close of its fiscal year. The Department may also request other information that will help it ascertain the impact of the CAPCO program both directly and indirectly on the economy of Georgia, including, but not limited to, the number of jobs created by qualified businesses that have received qualified investments.
State Report to the General Assembly	The Department is required to provide an annual report to the Governor and the chairs and ranking minority members of the committees having jurisdiction over taxes and economic development. The report must include: ▪ The number of CAPCOS holding designated capital; ▪ The amount of designated capital invested in each company; ▪ The cumulative amount that each company has invested as of January 1, 2012, and the cumulative total each year thereafter; ▪ The cumulative amount of follow-on capital that the investments of each company have created in terms of capital invested in qualified businesses at the same time or subsequent to investments made by a CAPCO in such businesses by sources other than the investment companies; ▪ The total amount of investment tax credits applied for each year; ▪ The performance of each CAPCO with regard to the requirements for continued certification; ▪ The classification of the companies in which each CAPCO has invested according to industrial sector and size of company; ▪ The gross number of jobs created by investments made by each CAPCO and the number of jobs retained; ▪ The location of the companies in which each investment company has invested; ▪ The CAPCOs that have been decertified, including the reasons for decertification; and ▪ Other related information as necessary to evaluate the effect of this legislation on economic development.