Labour-Sponsored Venture Capital Corporation Tax Credit Review 2002

Executive Summary

Labour-Sponsored Venture Capital Corporation Tax Credit

In Nova Scotia the Labour-Sponsored Venture Capital Corporation ("LSVCC") Tax Credit is legislated to lapse on December 31, 2003. It is a non-refundable 15 percent personal tax credit for investments in provincially registered LSVCCs. The maximum provincial tax credit is $525 per year ($3,500 X 15%) and the maximum federal tax credit is $750 per year ($5,000 X 15%).

A LSVCC is a venture capital investment fund sponsored by a labour organization with the general aim to create employment by making capital available to small and medium sized businesses. There have been approximately $68 million in LSVCC fund sales and $11 million in personal provincial credits claimed since the implementation of the credit in 1994. To November 2002, the LSVCCs have invested $20.7 million in 8 businesses with virtually all company investments being over $500,000. (Appendix A).

The key findings of the review are:

- The tax payback to the province is uncertain and the programme is not as effective as the Equity Tax ("ETC") credit and Community Economic Development Investment Funds ("CEDIF") credit in current economic stimulus and job creation.
- The many businesses seeking less than $500,000 in investment are outside the LSVCCs area of interest.
- The funds provide only a small percentage of the private investment capital in the province and they have invested in only 8 companies.
- The LSVCC have raised $68 million and actually have only $11.6 million in active investments (backing out bankruptcies).
- Alternatives are available such as the ETC and CEDIF programmes which provide tax incentives and a proposed Rule of the Nova Scotia Securities Commission, MI 45-103 Capital Raising Exemptions, if adopted will open additional avenues for businesses to raise capital.
- British Columbia, Manitoba, and New Brunswick have provincial LSVCCs to concentrate resources and provide local knowledge and focus.

Recommendation

Based on this review, the national LSVCC 's that have been approved for sale in Nova Scotia have not provided the expected results. In order to establish a more conclusive understanding of the effect on the economy LSVCC's should be closely monitored. To ensure this, the legislation should be extended only one year to December 31, 2004.

Description of Labour Sponsored Venture Capital Corporation Funds

A Labour-Sponsored Venture Capital Corporation ("LSVCC") is a venture capital investment fund sponsored by a labour organization with the general aim to create employment by making capital available to small and medium sized businesses. Theoretically, LSVCCs differ from traditional venture capital funds in that the LSVCC has significant mandates apart from achieving the highest return for investors. Generally, LSVCCs tend not to invest in seed capital or early stage companies as economies of scale require investments of $500,000 or more.

The Nova Scotia government encourages LSVCCs by way of the LSVCC tax credit, which is a 15 percent personal tax credit for investments in provincially registered LSVCCs legislated in Part II of the Equity Tax Credit Act. Individuals may receive a maximum provincial credit of $525 (based on a maximum investment of $3500) per year. Individuals may also receive a 15 percent federal tax credit up to a maximum $750 per year (on $5,000 of investment). The credit is not refundable and cannot be carried forward to future years.

Current Status

The LSVCC program was started in 1994 and through 2001, approximately $11 million in provincial tax credits have been claimed. Nova Scotia registered funds have raised approximately $68 million in the province since 1994. Funds raised prior to March 1, 2001, are required to place 60 percent of all funds raised in the province with Nova Scotia businesses within four years. Funds raised after March 1, 2001, are required to invest 60% in Nova Scotia businesses within two years. The current total minimum pool of funds for investment is approximately $8.5 million (60 percent of $14.2 million).

The LSVCCs have reinvested approximately 30.4 percent of all funds raised. The $20.7 million in investments have been made in 8 different companies for an average investment of about $2.59 million. (Appendix A)

Recent events in the investment climate have decreased funds dispersed by Venture Capitalists ("VC") to Atlantic Canadian businesses from $75 million in 2000 to $53 million in 2001(-29%). Investments in new businesses were not being made to the same degree as they were previously. VCs invested funds to strengthen firms they already held positions in without undertaking additional due diligence expenditures. It is thought that a viable venture capital industry in Nova Scotia would complete 5-7 transactions a year in the $.5 – $2.0 million range and 2-3 smaller early stage seed capital deals.

Analysis of LSVCCs

The LSVCC programme has had a direct tax credit cost to the Province of $11 million. Estimating the payback to the Province is extremely difficult because the impact of the LSVCC's investments on the economy is not immediately visible. As a general proxy the ETC and CEDIF programmes impact can be compared to that of the LSVCCs.

A comparison of the investment timing indicates; 1) the funds raised under the ETC programme are immediately invested and 2) the CEDIF programme has investment pacing requirements which are more demanding than LSVCCs. Therefore all else being equal the payback period to the Province for LSVCC tax credits is longer than that of the ETC or CEDIF programmes due to the later initial investment. Additionally one LSVCC has created a Nova Scotia investment company, which further delays any economic effects as pacing is met by investing in this business but actual active investments take place later. The slower payback for LSVCC tax credits results in a diminished multiplier effect throughout the economy when compared to the ETC and CEDIF programmes.

Incremental employment ratios for ETC investments are approximately one Person Year (PY) per $40,000 of investment. For CEDIF's the incremental employment ratio is estimated to be one PY per approximately $60,000 of investment. As the incrementality of LSVCC towards employment is unknown and cannot be calculated the ratio for investment to total business employment will be used (investment/total business employment). Where the total employment of the business and the investment by the LSVCC are known the ratio has ranged from a low of $17,058 per PY to a high of $300,000 per PY with an average of $87,453 per PY. As the investment/total business employment ratio is higher than the incremental effect of the ETC and CEDIF programmes it can be assumed that LSVCCs do not create current employment on investment as efficiently as the other programmes.

If sold after the hold period the proceeds from ETC and CEDIF shares cannot be reinvested in the same business to receive additional tax credits but LSVCC shares can be rolled over in the same fund and be eligible for additional tax credits on the same investment placing the ETC and CEDIF investments at an unfair disadvantage. The tax credit is an incentive to invest but after the hold period an investor's decision to re-invest should rely on the merits of the investment not on additional tax credits.

In eight years the ETC programme has assisted over 300 businesses. In three years the CEDIF programme has had investments in 16 businesses. In eight years LSVCCs have invested in 8 businesses. In Nova Scotia the major market requiring funds are seed and early stage businesses, which seek less than $500,000. LSVCCs are usually reluctant to provide less than $500,000 because of: 1) high due diligence costs in relation to the size of the funding, 2) the high investment risk of businesses with no revenue streams, 3) the level of equity invested would put the

LSVCC in a control position in the company and 4) relatively small businesses require more management mentoring from the LSVCC staff.

Clearly based on the assessment of current economic returns the LSVCCs do not match the other programmes. One explanation for this difference is LSVCC's aim to produce individual home run investments in the long term versus ETC and CEDIF, which generally support existing businesses and are more likely to generate short term results. Based on the performance to date the LSVCC investments in NS have an extremely low probability of generating returns of a magnitude capable of offsetting the current differences with ETC and CEDIF results. Also to be considered is the possibility that upon reaching commercial viability the investee business may relocate out of the province, decreasing the likelihood of eventual payback to the province.

Individual Nova Scotia investors in LSVCCs have benefited from the risk diversification provided by a fund of many projects across Canada, but outside of the tax credits have had very poor returns. From inception to October 31, 2002, only two of the funds registered in Nova Scotia have slightly positive investor returns (.55% and 1.09%) with management expense ratios ranging from 1.6% to 5.87% (average 3.58%).

Conclusion

While the impact of LSVCCs cannot be directly quantified the Province is not receiving benefits equal to those of other comparable tax credit programmes and it cannot be determined if the future benefits of LSVCC investments will actually occur. As a result of the pacing lag and the delay in active investing the actual amount invested by the LSVCCs is $11.6 million on sales of $68 million. LSVCCs do not provide funding to businesses requiring under $500,000. Finally, the funds are not outperforming alternative investments which could be made by investors.

Options

The critical mass required to support a competitive large scale LSVCC industry does not exist and is likely not to develop in Nova Scotia. LSVCCs are making some investments in the area but business expectations are not being met. The main seekers of capital are generally smaller businesses seeking limited expansion or early stage businesses both of which are unattractive to LSVCC funds due to the low capital requirement, under $500,000. In response to this the province can pursue several alternatives:

1. Extend The LSVCC Tax Credit Programme

The current LSVCC programme can be extended to December 31, 2006, as with the ETC and CEDIF programmes at an estimated annual tax credit cost of $1 -1.5 million per year. It can be expected that the same level of capital will be supplied but not all current concerns will be addressed. If this option is chosen the following changes to the Act and Regulations will be required.

a) Section 18A (2) add a subsection to prevent rollover of individual investments for tax credits on the same funds. An individual who sells or redeems their shares will not be eligible for further provincial tax credits on purchases of shares of the fund.

b) Regulation 13 modify the language “at any time” to prevent the LSVCC from making an investment then selling the investment and counting the investment as a contribution towards meeting the pacing requirement. The investment should be deemed to be held for only 9 months after disposal, this would give the LSVCC adequate time to reinvest.

c) Limits on the amount a LSVCC should be allowed to invest in a stock exchange-listed businesses should be implemented. The limit should be 15% of the capital required to be invested by the fund in the province unless the investment exists prior to the company becoming listed. (a stock exchange prescribed by Regulation 3200 or 3201 under the Income Tax Act (Canada)).

d) Added to Regulation 10 (a) a clause to allow for a purchaser of LSVCC shares to redeem within 60 days of purchase without repayment of the tax if the tax credit certificate is returned to the LSVCC.

e) Investment pacing requirements should flow through to businesses that are invested in by the LSVCC. The definition of active business (Income Tax Act section 248(1)) excludes specified investment business; a specified investment business that employs directly or indirectly 5 or more people is excluded from the definition of specified investment business (section 125(7)). Therefore specified investment businesses employing directly or indirectly 5 or more people are considered active businesses, an amendment to exclude these businesses from being considered active businesses should be made.

2. A Provincial Capital Fund

Various avenues to create a provincial fund can be examined:

A) Sales in national LSVCC funds could be suspended. The province could follow the example of British Colombia, Manitoba and New Brunswick and create a provincial Nova Scotia Venture Capital Corporation, which would concentrate resources and hopefully generate local expertise and focus investment on local needs. Until recently British Columbia restricted sales to one fund and their results have been more favourable than the others. Under this option there are likely to be significant initial funding, start up costs and operating costs that exceed revenues for the first several years of operations. A mutual fund in Nova Scotia must have $150,000 in securities or $500,000 in subscriptions and have a prospectus cleared through the Nova Scotia Securities Commission. Assuming a restriction on sales to just the one provincial fund, on sales of $7 million (recent average annual sales in Nova Scotia) only $250,600 of revenue would be generated at a management expense ratio of 3.58%(avg. of current funds). The revenues would grow as balances increased but interim funding would be required. The minimum size for a firm in Nova Scotia to economically raise and provide capital is estimated to be $30 million. Amendments to the programme would have to be in place to address the problems associated with current LSVCC's. Which are: 1) Investment pacing improvements, 2) investments under $500,000 should be a significant portion of their portfolio (due diligence would be labour intensive, 3) the effect on incremental employment should be a criteria for investment and 4) management expense ratios should be capped at a certain percentage with a dollar ceiling. This option mitigates concerns with the current programme but company selection, start up costs and the possibility of fund failure are among many further factors to be considered.

B) Allow other funds to continue operations and to draw investors a Nova Scotia fund would offer a higher tax credit rate. This fund would improve the NS focus but even with a higher tax credit rate it may be difficult to generate adequate capital. There would be no incentive for national funds to improve their Nova Scotia focus.

C) Suspend the national funds sales and expend the tax credit funds directly to ACF Equity Atlantic Inc or another venture capital fund with a Nova Scotia focus. This would place the funds directly in the hands of a venture capitalist with a Nova Scotia focus and improve capital distribution to Nova Scotia businesses. Without the leverage gained through the tax credit process the amount would be small and investors would lose the opportunity to save on taxes through investment.

In order to examine these options in addition to the changes proposed to the Act and Regulations under option #1 the lapse date should be extended only 1 year to December 31, 2004.

3. Do Not Renew the Legislation

Another option is to allow the legislation to lapse and have the market allocate capital to projects based on their perceived value. The push of capital by LSVCCs to businesses in Nova Scotia will decrease but attractive projects will obtain funding whether or not LSVCC tax credits exist. Marginal projects which benefited from the LSVCC push of capital into the province will have to improve their business cases to obtain funding and in the long run may be more successful. The market where the supply is deemed to be scarcest, the businesses seeking less than $500,000, will not be directly affected, as LSVCCs do not invest in that sector. The amount contributed to private sector investment in Nova Scotia by LSVCCs is minimal in relation to the total private sector investment therefore the funding can be contributed by alternate sources of funding such as venture capitalists or under tax incentive programmes such as ETC or CEDIF which are also more likely to satisfy businesses seeking under $500,000.

Recommendation

A one-year extension of the LSVCC programme to December 31, 2004, should be made. This will provide further time for 1) investment development, 2) examination for greater certainty of the economic results of the LSVCC programme and 3) examination of alternatives in capital funding for small and medium sized businesses in the province. To cancel the programme at this time may be premature and would present no flexibility for the establishment of a provincial fund under current legislation and if the programme was subsequently found to be positive for the province currently established funds might not enthusiastically re-enter the market.

Appendix A

WORKING VENTURES CANADIAN FUND INC.	**$**
The Maritime Beer Company Inc. Preferred & common shares March 14, 1997-B	1,200,000
Chitogenics Ltd. Preferred shares & warrants March 3, 1998	750,001
The Maritime Beer Company Inc. Convertible promissory note December 16, 1998-B	135,000
Nova Scotian Crystal Ltd. Common shares March 17, 1998	500,000
Salter Street Films Ltd. Common shares May 11, 1998-C	97,500
Chitogenics Ltd. Preferred shares March 15, 1999	750,000
Nova Scotian Crystal Ltd. Common shares July 20, 1999	200,000
Packetware Inc. Convertible preferred shares November 28, 2000(Trakonic Inc.)-B	1,000,000
Nova Scotian Crystal Ltd. Corporate Bond March 30, 2001	50,000
Chitogenics Ltd. Convertible preferred shares May 3, 2002	30,000
Packetware Inc. Convertible preferred shares August 21, 2002(Trakonic Inc.)-B	1
Total Investments to date	**4,712,502**
Triax	
Salter Street Films, May 1998-S	2,000,000
Salter Street Films New Media, May 1999 -C	1,500,000
Total Investments to date	**3,500,000**
Canadian Medical Discoveries Fund	
Medinnova Partners Inc., Oct. 2000 (2 Nova Scotia investments ($914,000))	6,550,000
Medinnova Partners Inc., Dec. 2001	3,500,000
Total Investments to date	**10,050,000**
Canadian Science & Technology Growth Fund	
Trakonic Inc., Dec. 2000-B	1,250,000
Trakonic Inc., Mar 2002-B	391,481
Trakonic Inc., May 2002-B	390,625
Trakonic Inc., Oct. 2002-B	100,000
Trakonic Inc., Nov. 2002-B	40,000
Total Investments to date	**2,172,106**
Lawrence	
Navitrak International, 2002	290,000
Total Investments to date	**290,000**
Retrocom	
Total Investments to date	
Venturelink	
Total Investments to date	

B=bankrupt S=sold C=control sold outside NS

Total All Investments to date	**20,724,608**