

Oversight Division

Committee On Legislative Research

Program Evaluation of Certified Capital Company Tax Credit

Program
Evaluation of Certified Capital
Company Tax Credit

*Prepared for the Committee on Legislative Research
by the Oversight Division*

Jeanne Jarrett, CPA, Director

Review Team:

Mickey Wilson, CPA, Team Leader, Robert Boone, Wayne Blair, Ross Strobe

December, 2000

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COMMITTEE ON LEGISLATIVE RESEARCH

OVERSIGHT SUBCOMMITTEE

THE COMMITTEE ON LEGISLATIVE RESEARCH, Oversight Division, is an agency of the Missouri General Assembly as established in Chapter 23 of the Revised Statutes of Missouri. The programs and activities of the State of Missouri cost approximately \$17 billion annually. Each year the General Assembly enacts laws which add to, delete or change these programs. To meet the demands for more responsive and cost effective state government, legislators need to receive information regarding the status of the programs which they have created and the expenditure of funds which they have authorized. The work of the Oversight Division provides the General Assembly with a means to evaluate state agencies and state programs.

THE COMMITTEE ON LEGISLATIVE RESEARCH is a permanent joint committee of the Missouri General Assembly comprised of the chairman of the Senate Appropriations Committee and nine other members of the Senate and the chairman of the House Budget Committee and nine other members of the House of Representatives. The Senate members are appointed by the President Pro Tem of the Senate and the House members are appointed by the Speaker of the House of Representatives. No more than six members from the House and six members from the Senate may be of the same political party.

EVALUATIONS ARE ASSIGNED to the Oversight Division pursuant to a duly adopted concurrent resolution of the General Assembly or pursuant to a resolution adopted by the Committee on Legislative Research. Legislators or committees may make their requests for program evaluations through the Chairman of the Committee on Legislative Research or any other member of the Committee.

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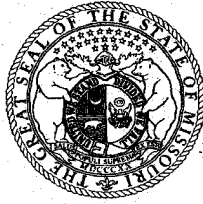
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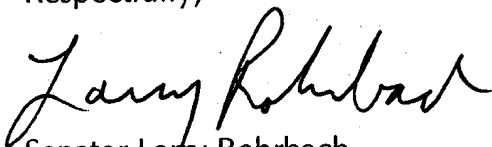
STATE CAPITOL
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February 28, 2001

Members of the General Assembly:

As authorized by Chapter 23, RSMo, the Committee on Legislative Research adopted a resolution on May 11, 2000 directing the Oversight Division to perform a program evaluation of the Certified Capital Company Tax Credit Program which included the examination of records and procedures in the Department of Economic Development to determine and evaluate the tax credit program performance in accordance with the program's objectives, responsibilities, and duties as set forth by statute or regulation.

Respectfully,


Senator Larry Rohrbach
Chairman

The accompanying report includes Oversight's comments on internal controls, compliance with legal requirements, management practices, program performance and related areas. We hope this information is helpful and can be used in a constructive manner for the betterment of the state program to which it relates.

EXECUTIVE SUMMARY

The Certified Capital Company Tax Credit Program was enacted by the Missouri General Assembly during the 1996 legislative session with an effective date of January 1, 1997. The intent of the program is to induce private investment by insurance companies into new or expanding eligible Missouri small businesses, which will result in the creation of new jobs and investment. Private venture capital firms (CAPCOs) invest the money contributed by insurance companies in the small businesses. The insurance companies' cost is then underwritten by the State in the form of tax credits. Initially, the legislature authorized \$100 million in tax credits to be used by insurance companies to offset future premium tax liabilities, of which \$50 million was to be issued in the first year. The law was later expanded to allow the credits to be used to offset other state taxes and, in 1998, an additional \$40 million in credits was authorized by the General Assembly. The Department of Economic Development is the administering agency.

Oversight was unable to assess the economic benefit of CAPCO investment to the State because data possessed by the Department of Economic Development was unreliable. For instance, a major factor in determining economic benefit is the number of new jobs created by an investment. When Oversight reviewed this data submitted by companies and compared it to records maintained by the Missouri Division of Employment Security, it was apparent that the number of jobs for certain companies was overstated. For three companies, the number of jobs was overstated by a total of 775 direct Missouri jobs, which further calculates into 1,038 indirect Missouri jobs, \$3,548,740 in business taxes, and \$1,280,169 in state income taxes. Without accurate information regarding the number of new Missouri jobs created, it is difficult to determine the extent to which the state is benefitting from investment in the program.

A review of the records related to the program revealed that as of June 30, 2000, the CAPCOs had invested only \$48 million of the \$140 million of the funds provided by insurance companies in qualified small businesses. The remainder, \$92 million, was being held or invested by the CAPCOs where they deemed appropriate. This essentially means that 66% of the funds contributed by insurance companies were not being used for the intended purpose of providing capital for start-up or expanding Missouri businesses. It also permitted the loss of \$9.2 million in state revenue for tax credits on funds not invested in qualified Missouri small businesses. State law provides a mechanism for reducing the amount of credits insurance companies can claim in a fiscal year. Oversight recommends the tax credit percentage be reduced to more closely represent investments in qualified small businesses.

Oversight recommends certain procedural safeguards in order to protect the state's interests. Currently, there are no provisions regarding payback of credits when invested companies leave the state of Missouri. In fact, one business was acquired by another company and did move their headquarters out-of-state after receiving \$3.7 million in CAPCO funding.

The Department of Economic Development should strive to provide accurate information to the Legislature and to state budget officials regarding tax credits authorized and claimed. Additionally, reconciliation between the Departments of Economic Development, Insurance and

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The Department of Economic Development should strive to provide accurate information to the Legislature and to state budget officials regarding tax credits authorized and claimed. Additionally, reconciliation between the Departments of Economic Development, Insurance and

Revenue could provide greater accountability.

Overall, Oversight recognizes the long-term nature of the CAPCO program and recommends that an evaluation of the program be undertaken once it has been operational for five to seven years. At that point, the success or failure of business investments can more readily be gauged.

The Oversight Division did not audit departmental financial statements and, accordingly, does not express an opinion on them. We wish to acknowledge the cooperation and assistance of staff in the Department of Economic Development during the course of the evaluation.

A handwritten signature in black ink, appearing to read "Jeanne Jarrett". The signature is written in a cursive style with a large initial "J".

Jeanne Jarrett, CPA

OVERSIGHT DIVISION
Program Evaluation
Certified Capital Company Tax Credit Program

A private venture capital firm must submit an application containing various affidavits and information (see Exhibit A) to DED to become a CAPCO. If the application is approved, the CAPCO is eligible to raise funds from insurance companies. All CAPCOs are not provided an allocation of tax credits, only those CAPCOs that are able to raise funds receive the tax credits. CAPCOs must invest at least 25% of their total investments within two years of their date of certificate; 40% must be invested within three years; and 50% must be invested by the end of the fourth year. CAPCOs must be 100% invested before any distributions of profits can be made.

The purpose of the Program is to induce private investment into new or expanding Missouri small businesses which would result in the creation of new jobs and investment. DED will issue a state premium tax credit to an insurance company that makes an investment in a CAPCO. The only eligible investor in a CAPCO is an insurance company having a premium tax liability in Missouri. DED provides the investor a tax credit equal to 100% of their investment in a CAPCO. The investor may take the tax credit at a rate of up to 10% over a ten-year period. The tax credits may be used to offset state premium tax liability. The tax credits may be sold and transferred to another taxpayer having premium tax liability. The maximum amount of certified capital in one or more CAPCOs for which earned and vested tax credits would be allowed in any year to any one investor or its affiliates is limited to \$10 million.

A CAPCO may invest in an eligible business that is in need of venture capital and cannot obtain conventional financing. The eligible businesses must derive their revenue primarily from manufacturing, processing or assembling of products, conducting research and development, or service businesses which can demonstrate that at least 33% of their revenue would be from outside the state of Missouri. Businesses must be independently owned, headquartered in Missouri, and employ less than 200 persons before the investment is made. The annual revenue of the business in its last fiscal year must be less than \$4 million or if the business is more than 3 years old, the revenue limit is \$3 million. Effective January 1, 1999, eligible businesses also include those located in "distressed communities". The annual revenue of the business located in a "distressed community" must be less than \$5 million.

The CAPCO funds invested in the business must be used for new capital improvements, research and development, and certain working capital expenses. All such funds must be used in Missouri. The amount a CAPCO may invest in one Missouri business depends on various factors; however, the maximum amount is

Chapter 1 - Introduction

The Joint Committee on Legislative Research directed the Oversight Division to conduct a program evaluation of the Certified Capital Company Tax Credit Program within the Department of Economic Development. The evaluation had the following components: to determine the effectiveness of the tax credit program, the benefits of the program in relation to expenditures, the goals of the tax credit program, the development of indicators by which the success or failure of the program may be gauged, the conformity of the program with legislative intent, and the impact of any federal grant programs on the program.

Background

The Department of Economic Development (DED) administers the Certified Capital Company (CAPCO) tax credit program (Program). The Program became effective on January 1, 1997. The Program's intent is to induce private investment into new or expanding eligible Missouri small businesses, which will result in the creation of new jobs and investment, by initiating the formation of private venture capital firms ("CAPCOs") that invest in eligible Missouri small businesses. Certified capital companies are partnerships, corporations, trusts, not-for-profit, or limited liability companies located, registered, and headquartered in Missouri that have as their primary business activity the investment of cash in qualified Missouri businesses. CAPCOs must be certified by DED. However, once a CAPCO has been certified, DED does not have the authority to require a CAPCO to fund a project.

The Program was enacted by House Bill 1237 during the 1996 legislative session with an effective date of January 1, 1997. HB 1237 authorized \$100 million in tax credits for insurance companies as an offset against future premium tax liabilities. However, HB 1237 authorized DED to issue up to \$50 million of these tax credits during calendar year 1997 and up to an additional \$50 million during any calendar year thereafter. Senate Bill 1, enacted during the 1997 special session, amended the enabling legislation by expanding the types of taxes that the tax credits could be claimed against and limited the amount of tax credits that could be claimed by any one investor to \$10 million in one year. In addition, during the 1998 legislative session, House Bill 1656 was enacted authorizing an additional \$40 million in tax credits to be issued in calendar year 1999 or future years as determined by DED.

15% of the CAPCO's certified capital. Funding decisions are made by each CAPCO based on their evaluation of the return on investment relative to the risk. CAPCO funds may be used for equity investments, unsecured loans, or hybrid investments in eligible businesses. Typically, venture capitalists require a projected 25-40% annual rate of return depending on the risk. A CAPCO may either purchase stock in the company or make an unsecured loan. Repayment would be negotiated between the CAPCO and the business. There are no particular program requirements on the length, terms, or other combinations except that the loan may not be secured. DED does not have the authority to require a CAPCO to fund a project. Small businesses interested in receiving funding through this program may contact each CAPCO directly, or they may contact DED to obtain CAPCO information.

Objectives

The evaluation had the following components: to determine the effectiveness of the program, the benefits of the program in relation to expenditures, the goals of the program, the development of indicators by which the success or failure of the program may be gauged, and the conformity of the tax credit program with legislative intent.

Scope/Methodology

The scope of the evaluation concentrated on the effectiveness and efficiency of the Certified Capital Companies Tax Credit Program for the time period July 1, 1995 through June 30, 2000. The methodology used by the Oversight Division included tests of samples of transactions and evaluations of management controls to the extent necessary to fulfill evaluation objectives. A primary method used to measure objectives was conducting personal interviews with agency personnel. Additionally, the evaluation included performing on-site testing of controls and procedures.

Chapter 2 - Comments

Comment #1

The Department of Insurance does not reconcile the amount of credits it approves to the amount allocated to the General Revenue Fund and the County Foreign Insurance Tax Fund by the Department of Revenue.

For fiscal years 1997 through 2000, Oversight compared the amount of premium taxes and CAPCO tax credits to the amounts credited to the state General Revenue Fund and the County Foreign Insurance Tax Fund. The Department of Insurance (INS) reports the premium taxes and CAPCO tax credits claimed to the Department of Revenue (DOR). DOR allocates the premium taxes between the two funds. Section 148.360 RSMo provides that the County Foreign Insurance Tax Fund allocation shall not be reduced by any CAPCO tax credits. Oversight noted that \$45,350 of 1998 premium taxes were not credited properly to the County Foreign Insurance Tax Fund. Without periodic reconciliation between the INS and DOR, there are no assurances that the amounts of premium taxes and CAPCO tax credits are being properly allocated. In effect, this inaccurate allocation resulted in the County Foreign Insurance Tax Fund being shorted \$45,350 for the year. Subsequent to Oversight's finding, the Department of Revenue began taking steps to correct the situation.

Oversight recommends that the Department of Insurance and the Department of Revenue create and implement a system that would allow for periodic reconciliation.

Comment #2

The Department of Economic Development is not required by statute to report to the Governor and to the General Assembly on the status of the Program and the return on investment received by the state.

Oversight compared the statutes of the four states that have similar CAPCO programs to Missouri. In the comparison, Oversight noted that Missouri's statutes do not require the Department of Economic Development to report to the Governor and the General Assembly regarding the success of the CAPCO program. For example, the Florida General Assembly requires the department that administers the CAPCO program in their state to annually report on the status of the program. Examples of items covered in the Florida report include:

- The total dollar amount each CAPCO has received from investors, identifying the investors, and total tax credits used by each certified investor.
- Total dollar amounts invested in qualified businesses as well as the number of permanent, full-time jobs created or retained by each qualified business
- The return on investment to the state for the cost of the program to taxpayers. This return takes into account the employment growth, the wage level of the businesses receiving CAPCO funds, as well as the investment's impact on diversifying the economic base of the state.

This report would provide essential information to the Governor and the General Assembly that could be used in making decisions regarding possible legislative/finding changes.

Oversight recommends that the General Assembly consider adopting legislation that would require the Missouri Department of Economic Development to submit an annual report to the Governor and the Legislature.

Comment #3

No provisions are currently in place to deter qualified Missouri businesses that have received CAPCO monies from leaving the State of Missouri for other locations.

Oversight noted that Missouri's statutes do not contain any provisions that would discourage qualified Missouri businesses that have received CAPCO money from leaving the state for other locations. For example, Oversight noted a qualified Missouri business that had received \$3,709,632 of investment from a CAPCO. Subsequent to the investment, the business was purchased by another company and the headquarters moved from Missouri. There are no current provisions to discourage or penalize businesses that leave the state of Missouri after receiving money from the CAPCOs financed ultimately by the state through tax credits.

Oversight recommends that the General Assembly consider adopting legislation that would address the issue of qualified Missouri businesses receiving CAPCO money and then moving out of the state. The following are two examples that could be considered by the Legislature:

- If a qualified Missouri business moves part or all of its operations out of the state, the Department of Economic Development could possibly reclassify the investment as one *not* in a qualified Missouri business, therefore, not qualifying for the two, three and four year investment thresholds. It would then be in the best interest of the CAPCO to ensure that the qualified Missouri business remains in Missouri.
- Have as a condition of the investment of a CAPCO into a qualified Missouri business that they must remain in the state of Missouri, or risk being required to return the investment plus additional compensation to the CAPCO upon moving the businesses (or portion thereof) across the state line. This would place the burden and risk on the qualified business to remain in Missouri.

Oversight recommends that the General Assembly consider adopting legislation that would require the qualified Missouri businesses that have received money from CAPCOs to retain their operations in the state, so that Missouri taxpayers may benefit from the investments.

Comment #4

On several occasions, inaccurate information was given by the Department of Economic Development to the Office of Administration, Division of Budget and Planning regarding the amounts of tax credits to be utilized. The Division of Budget and Planning uses this information to produce revenue projections for a given fiscal year.

Oversight compared the reports prepared by the DED for the last three fiscal years and noted several large discrepancies between the projected CAPCO credits that may be utilized (per DED) and the actual credits available per the revised State Statutes. Oversight also noted several large discrepancies between the actual CAPCO credits that were utilized (per DED) and the total credits used per the Department of Insurance

The report, Budget Form 14 (Deductions, Exemptions, Credits, and Other Tax Preferences) is used by various state agencies to convey the actual and projected decreases in revenue as a result of tax credit programs. If these estimates are incorrect, the overall revenue projections for the state may be misstated.

The effect of inaccurately estimating the reduction in annual revenue as a result of the CAPCO tax credit program would be an inaccurate budget forecasted for a given year. For example, regarding Fiscal Year 1999, the Department of Economic Development projected an estimated impact to the insurance premium tax revenue stream of \$5 million, while the tax credits taken in that year were capped by statute at \$14 million, and actual credits totaled roughly \$13.4 million. This large discrepancy could have a serious impact on the state's budget process.

Oversight recommends that the Department of Economic Development, use both the statutory limits of annual tax credits available to insurance companies and the actual tax credits utilized in the previous year (according to the Department of Insurance) in their preparation of Form 14. For the first two years of tax credits, insurance companies used nearly all of the premium tax credits available to them and carried forward very little. Therefore, if this trend continues, actual tax credit utilization should closely resemble statutory ceilings for CAPCO credits. This would aid the Division of Budget and Planning in assembling the annual budget.

Comment #5

The Department of Economic Development is not complying with the rules and regulations requiring the reporting of sale/transfer of certified capital companies tax credits between insurance companies within a specified time frame.

CSR 80-7.040 (1) (F) states that the Department of Economic Development (DED) must be notified within thirty days of a transfer/sale of certified capital companies tax credits between insurance companies or the transaction is void. Oversight reviewed sixteen transfers/sales of tax credits during the evaluation period and noted four transfers/sales that exceeded the thirty day window of opportunity. The four transfers/sales exceeded the required time frame by up to 47 days and totaled approximately \$1,338,935 in tax credits.

Failure by DED to monitor the transfer/sale of certified capital companies tax credits may allow insurance companies to buy/sell these tax credits beyond the specified time frame.

Oversight recommends that the Department of Economic Development monitor more closely the transfer/sale of certified capital companies tax credits between insurance companies.

Comment #6

The Department of Economic Development does not verify the number of new jobs created in companies with investments from certified capital companies. Information received by DED could have overstated the number of jobs created by several hundred direct jobs and over one thousand indirect jobs.

The Department of Economic Development (DED) has a policy for the Certified Capital Company (CAPCO) Tax Credit Program that is intended to induce private investment into new or growing qualified Missouri small businesses which would result in the creation of new jobs and investment. This policy requires that if the investment would result in the creation of new jobs, the CAPCO must report to DED how many new jobs are being created. During Oversight's evaluation of the tax credit program, it was noted that DED does not verify the number of new jobs created. Oversight contacted the Division of Employment Security to obtain the number of Missouri-wage paid jobs reported by qualified small businesses. Oversight compared the number of new jobs reported by the CAPCOs to the information received from the Division of Employment Security. Oversight noted a difference of 775 fewer jobs between the new jobs reported by the CAPCOs and the Division of

Employment Security.

DED prepares an annual report based on the number of new jobs reported by the CAPCOs. The economic impact of these new jobs is entered into an economic model projection system called the Regional Economic Model Indicator (REMI). REMI has the ability to project the number of new indirect jobs, the direct and indirect business taxes, and state income taxes. Oversight requested that DED determine the economic impact on the three companies with the largest reported number of new jobs using the number of jobs reported by the Division of Employment Security. In comparing the information between the REMI reports, Oversight noted a decrease of 1,038 indirect jobs, a decrease of \$3,548,740 in business taxes, and a decrease of \$1,280,169 in state income taxes.

Without accurately documenting the number of new jobs being created, the Department of Economic Development cannot properly assess the effectiveness of the Certified Capital Companies Tax Credit Program.

Oversight recommends that the Department of Economic Development, in order to properly assess the effectiveness of the Certified Capital Companies Tax Credit Program, should verify the new employment numbers with the Division of Employment Security.

Comment #7

Oversight was unable to determine the program's effectiveness due to unreliable data.

Based on current investments in Missouri businesses and employment data provided by the CAPCOs, the Department of Economic Development (DED) prepared an economic benefits analysis that projected an economic benefit to the state of \$12.2 million in new business/income taxes. The cost to the state is \$14 million in premium tax credits claimed by insurance companies. However, as noted in Comment #6, the employment data provided by the CAPCOs overstates the number of new direct jobs created by these investments in qualified

Missouri businesses. In analyzing the amount invested in qualified Missouri businesses, Oversight was unable to assess the effectiveness of this tax credit program due to unreliable employment data.

The DED analysis and Oversight's analysis were at a certain given point in time. With the first investments in qualified Missouri businesses being made in fiscal year 1998, a better analysis may be made after a longer time period, such as five to seven years. This longer period would allow sufficient time for businesses to either prosper or fail. The longer period would also allow for a more in-depth analysis on the rate of return for the insurance companies. Oversight's analysis of only three fiscal years after the inception of the program may not have been an adequate time frame to determine if there is a net positive or net negative impact to the state as a result of this tax credit program.

In analyzing the amount invested in qualified Missouri businesses, Oversight was unable to assess the effectiveness of this tax credit program due to unreliable employment data.

Comment #8

Instances were noted where an officer of a Certified Capital Company was also found to be an officer of the qualified Missouri business that the Certified Capital Company had invested in. This could be considered a conflict of interest.

Investments were made by a CAPCO into qualified Missouri businesses even though the director of the CAPCO was also a member of the Board of Directors of the business. Nothing in the Revised Statutes nor in the Rules and Regulations prohibits this, however, Oversight feels this is an apparent conflict of interest and may be construed as the individuals steering CAPCO money to their companies and perhaps personally benefitting from the transactions.

Oversight compared the directors listings from all of the qualified Missouri businesses receiving CAPCO investments to the officers, agents and affiliates of the CAPCOs. Three persons were determined to have been affiliated with the CAPCOs as well as companies that

the CAPCOs have invested in. One of these persons received the Board of Directors position after his CAPCO made their initial investment, which seems to be simply the investor fulfilling a fiduciary responsibility of overseeing the CAPCO's investment. However, two of the persons received their officer's position in the qualified Missouri businesses before the CAPCO invested in their company. The Department of Economic Development stated that these officers received their positions in the qualified Missouri businesses after another fund managed by CAPCO's affiliate invested in the same company.

The effect of CAPCOs investing in companies with which they share an officer could be the perception that these dual-officers are in a position to steer CAPCO monies (which are, indirectly, state of Missouri's taxpayers monies) to the qualified Missouri businesses that they manage. The business transaction could be completely legitimate and above-board, however, it may still be perceived by the general public as an impropriety.

Oversight recommends that the Department of Economic Development adopt regulations prohibiting situations which may create conflicts of interest. The CAPCO could either include statements of compliance in the signed affidavits that their officers must submit in the application process, or DED could verify with the Secretary of State's Office that there are no such conflicts of interest before the investment takes place.

Comment #9

The Department of Economic Development should consider implementing an initial registration fee and an annual renewal fee for certified capital companies wishing to do business in the state of Missouri.

During Oversight's review of the Certified Capital Company Tax Credit Program (CAPCO), it was noted that the Department of Economic Development (DED) has not implemented an initial registration fee and annual renewal fee for certified capital companies wishing to do business in the state of Missouri. Statutory and/or regulatory authority has not provided for the collection of licensing fees by DED to offset the cost of administering the program.

For FY 2000, Oversight estimates the state of Missouri spent approximately \$30,000 in direct costs (salaries, fringe benefits, expense and equipment, etc.) associated with the administration of the CAPCO tax credit program. The implementation of a registration and/or renewal fee would cover or offset the cost that DED incurs in administering the program currently. All costs of administering CAPCOs are funded by the state.

Oversight recommends the Department of Economic Development consider seeking legislative approval for an initial registration fee and/or annual renewal fee for all certified capital companies doing business in the state of Missouri. The fees would be used to partially offset the cost of administering the program by the state.

Comment #10

Insurance companies are allowed to utilize tax credits on amounts not invested in qualified Missouri businesses.

Section 135.516.1 RSMo requires a certified capital company (CAPCO) to make investments of its certified capital in qualified Missouri businesses of at least twenty-five percent within two years, forty percent within three years, and fifty percent within four years. These minimum investment requirements have not affected the amount of premium tax credits claimed by insurance companies. As of June 30, 2000 the CAPCOs had \$48 million out of the \$140 million provided by the insurance companies invested in qualified Missouri businesses. Section 135.516.1 (5) RSMo, allows CAPCOs to invest their certified capital that is not invested in qualified Missouri

businesses in investments that the CAPCO deems appropriate. Based on these investments and employment data provided by the CAPCOs, the Department of Economic Development (DED) prepared an economic benefit analysis that projected a positive impact to the state of \$12.2 million in new business/income taxes. The cost to the state was \$14 million in premium tax credits claimed for the year by insurance companies. If the premium tax credits would have been allowed only on the amounts invested, the cost to the state would have been \$4.8 million, saving the state \$9.2 million in tax credits claimed. In addition, the net positive impact to the state would be \$7.4 million versus a net negative impact of \$1.8 million under the current scheme. Section 135.503 RSMo allows the director of the Department of Insurance, with the approval of the Commissioner of Administration, to reduce the percentage of premium tax credits claimed.

Oversight recommends the Department of Insurance, in conjunction with Office of Administration, consider lowering the applicable percentage of tax credits allowed to reflect the amounts invested by the CAPCOs. This would result in a more positive outcome for Missouri taxpayers.

APPENDIX 1

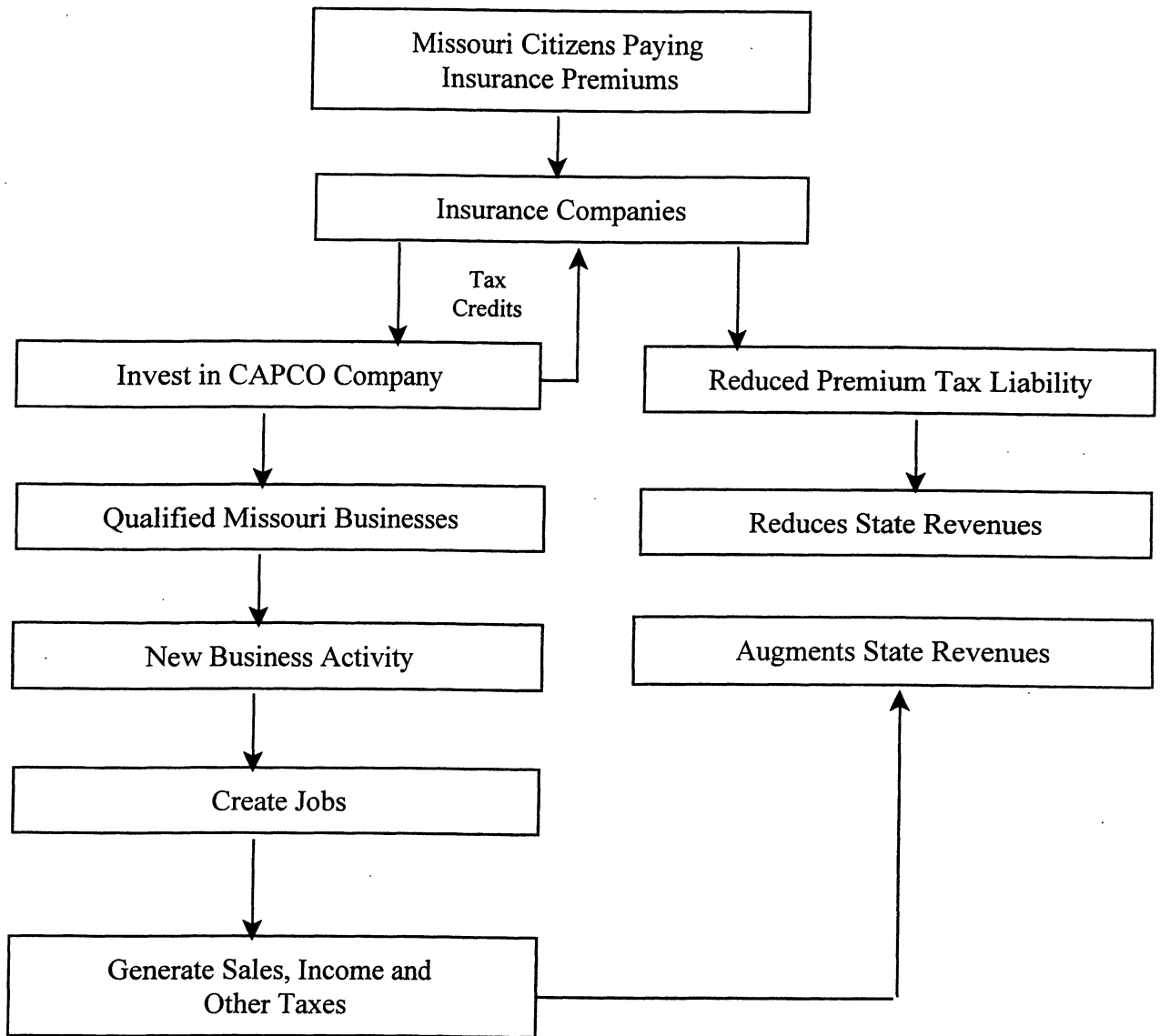
Department of Economic Development
Certified Capital Company Tax Credit Program
Schedule of Tax Credits Allowed and Tax Credits Claimed

Appendix 1

UNAUDITED

<u>Fiscal Year</u>	<u>Tax Credits Allowed</u>	<u>Tax Credits Claimed</u>
1997	\$5,000,000.00	\$4,977,731.00
1998	10,000,000.00	9,846,700.00
1999	<u>14,000,000.00</u>	<u>13,354,511.00</u>
Total	<u>\$29,000,000.00</u>	<u>\$28,178,942.00</u>

APPENDIX 2



APPENDIX 3



Bob Holden
Governor

Joseph L. Driskill
Director

January 16, 2001

Ms. Jeanne Jarrett, CPA
Director
Legislative Research Committee
Oversight Division
Room 132 State Capitol
Jefferson City, MO 65101

Dear Ms. Jarrett:

This letter is in response to the Oversight Division's evaluation of the Certified Capital Companies Tax Credit (CAPCO) program. Thank you for giving the Department of Economic Development (DED) the opportunity to respond to the comments.

DED did not originate or propose the idea for the CAPCO legislation. The General Assembly enacted the legislation after numerous attempts by the proponents of the concept, in particular Advantage Capital Partners. However, DED does believe the program has positively impacted the amount of venture capital, both directly and indirectly, brought into the state over the past few years and has played a major role in increasing the economic development activity in Missouri, particularly in the St. Louis area. As to the question of whether or not this program is cost-effective, we will leave it to others to judge.

Comment #1: The Department of Insurance does not reconcile the amount of credits it approves to the amount allocated to the General Revenue Fund and the County Foreign Insurance Tax Fund by the Department of Revenue.

DED concurs with the recommendation made by the Oversight Division that the Department of Insurance and the Department of Revenue should develop and implement a tracking system to reconcile redeemed CAPCO tax credits against the amount allocated to the General Revenue Fund and the County Foreign Insurance Tax Fund.

Ms. Jeanne Jarrett
January 16, 2001
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Comment #2: On several occasions, inaccurate information was given by the Department of Economic Development to the Office of Administration, Division of Budget and Planning regarding the amounts of tax credits to be utilized. The Division of Budget and Planning uses this information to produce revenue projections for a given fiscal year.

DED realized the error in the Form 14 (budget form) reported to OA Budget and Planning for FY99. The correction was made to that fiscal year's Form 14 and no error has occurred since that time.

Comment #3: The Department of Economic Development is not required by statute to report to the Governor and to the General Assembly on the status of the Program and the return on investment received by the state.

Although this comment recommends action by the General Assembly, DED would like to note that a report is prepared each year by the Office of Business Finance, Business Development Group and submitted to the Director of DED. While this report is not intended to analyze the effectiveness of the CAPCO program, it does include total dollar amount invested by each CAPCO in qualified businesses, as well as, the number of jobs created as reported by the CAPCOs. Should the General Assembly enact a law requiring an annual report, DED would certainly submit such an annual report to the General Assembly and the Governor.

Comment #4: No provisions are currently in place to deter qualified Missouri businesses that have received CAPCO monies from leaving the State of Missouri for other locations.

DED is in agreement with this comment regarding adopting provisions that would discourage qualified Missouri businesses from moving out of the state. However, it is not unusual in a high-tech environment when a company is in the early stages of development for an acquisition by a larger corporation to occur. In the few instances where this did happen, the CAPCO was able to negotiate for stock from the larger company. Additionally, even though the headquarters ultimately moved out of the state, the companies continue to maintain a presence in Missouri. We do, however, concur with the concept and realize that only by keeping the companies in the state will we reap the entire benefit of their success. This recommendation would require legislative changes adopted by the General Assembly.

Comment #5: The Department of Economic Development is not enforcing the rules and regulations requiring the reporting of sale/transfer of certified capital companies tax credits between insurance companies within a specified time frame.

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The Oversight Division reported that there were four instances when a sale/transfer of a tax credit exceeded the 30-day period established according to 4 C.S.R. §80-7.040(1)(F). DED admits that four transactions exceeded the time frame in that three transactions had 44 days between the time of the transfer and DED notification and one transaction with a 77-day period.

While a handful of transferable tax credits have a 30-day notification requirement, in those cases it is required by statute, and the majority of transferable tax credits have no such requirement. For all, however, the transfer is not perfected (effective in the eyes of the state) until the administering agency has been notified. In practice, the administrator then issues new certificates reflecting the transfer and voids previous certificates, and notifies the taxing agency of same. Until the new certificates have been issued, the taxing authority would not recognize the tax credits as having transferred to the new owner. Given this system, and that the predominant system is to not impose an exact time period, DED does not deem this "failure to enforce" a meaningful one.

Furthermore, it is questionable whether DED could lawfully enforce the 30-day requirement of 4 C.S.R. §80-7.040(1)(F). DED will consider amending the regulation to do away with the 30-day requirement.

Comment #6: Instances were noted where an officer of a Certified Capital Company was also found to be an officer of the qualified Missouri business that the Certified Capital Company had invested in. This could be considered a conflict of interest.

Under this comment, Oversight recommends that DED adopt regulations prohibiting situations which may create a conflict of interest, in particular where an officer of the CAPCO was also found to sit on the Board of Directors of the qualified business receiving a CAPCO investment. Currently, neither the statutes nor the regulations prohibit this.

DED believes that illustrating the instances will provide some insight into the issues that must be considered before imposing such a prohibition.

The first instance deals with Advantage Capital I and II and the qualified company of Birch Telecom. After the initial investment by Advantage Capital I, David Bergmann, an officer of Advantage Capital Partners, was given a seat on the board of directors for Birch Telecom. Advantage then made follow-on investments from Advantage I and II CAPCOs. It is commonplace for an officer of a venture capital firm to take a seat on the board of directors of a portfolio business after an investment is made. The person placed on the board can then be involved with the day-to-day operations and management decisions of the business and better protect the investment.

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The law clearly recognizes that follow-on investments may occur (§135.500.1(13), RSMo 2000). To prohibit representation on the board would put the CAPCO investors – effectively the state of Missouri, at a disadvantage. It would either discourage follow-on investments, which is contrary to what is contemplated by the law, or it would discourage board of director participation by the CAPCO, which would be contrary to the interests of the investor, especially in venture capital situations.

In the other two instances, Gateway Associates manages several private venture capital funds, while also managing BOME CAPCO I and II. In two cases, Dr. Greg Johnson and John McCarthy, both officers of Gateway, held positions on the board of director's of two businesses before a CAPCO investment was made in the business. This was due to the fact that the private venture capital funds managed by Gateway had previously invested in the businesses. The businesses were later qualified under the CAPCO program, meeting all of the necessary requirements of a qualified Missouri business, and CAPCO investments were made.

Most if not all of Missouri's CAPCO managers also manage private venture capital funds. Frequently, the CAPCO investment can leverage private investment, regardless of the precise time sequence of events. To prohibit CAPCO investments where previous private fund investments were made is something that must be given serious consideration so as not to hinder the leverage of private investment that the CAPCO investments bring about.

While we do not perceive these instances to be prohibited by the applicable law as a conflict of interest, DED agrees to implement a policy to verify with the Secretary of State's Office the officers/board of directors before approving a business as "qualified."

Comment #7: The Department of Economic Development should consider implementing an initial registration fee and an annual renewal fee for certified capital companies wishing to do business in the state of Missouri.

DED will take this comment under consideration.

Comment #8: Insurance companies are allowed to utilize tax credits on amounts not invested in qualified Missouri businesses.

DED will entertain conversations with the Department of Insurance and the Office of Administration to discuss this comment.

Comment #9: The Department of Economic Development does not verify the number of new jobs created in companies with investments from certified capital companies. Information received by DED could have overstated the number of jobs created by several hundred direct jobs and over one thousand indirect jobs.

The law does not require the CAPCOs to create jobs in Missouri. We encourage the CAPCOs to report jobs to DED, but it is not a requirement founded in the statute. While the Office of Business Finance prepares an annual report, it is an internal report and is not currently used to assess the effectiveness of the CAPCO program.

Oversight, in its review, compared the number of jobs reported by the CAPCOs to the Division of Employment Security Missouri-wage paid jobs reported by qualified small businesses and determined that DED overstated the job creation number reported by the CAPCOs. The number of jobs reported by the CAPCOs includes all jobs being created – Missouri jobs and jobs being created in other states, as several of the qualified companies have offices in other states.

According to the Division of Employment Security, jobs can be tracked through quarterly Unemployment Insurance Tax reports that each Missouri employer must complete. However, these reports lag by one quarter and only include employees of the company's Missouri location. Therefore, if an employer also owns an office in Kansas or Illinois, the company would file an Unemployment Insurance Tax report in those states. Historically, states have not shared their unemployment insurance databases with each other. As stated above, several companies under the CAPCO program have offices in other states and are creating jobs in those states. So, the job creation numbers being reported to DED include those out of state jobs. DED will continue to track the Missouri and out of state jobs separately.

Comment #10: Oversight was unable to determine the program's effectiveness due to unreliable data.

DED concurs with the recommendation that there be a detailed study of the CAPCO program in the fifth year of the program – FY2003. We agree that a sufficient amount of time has not yet passed to determine the effectiveness of the program.

Several studies have been conducted over the past few years including: "The Certified Capital Companies Economic Development Innovation: Missouri's Experience to Date" prepared by IC² Institute; "A Critical Review of the IC² Institute Report" by the Rural Policy Research Institute; and "A Study of Missouri Tax Credits and Incentives" by the Barents Group, LLC.

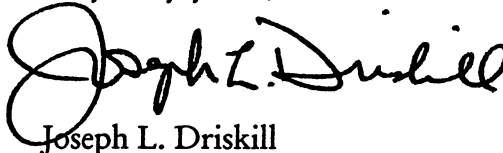
Ms. Jeanne Jarrett
January 16, 2001
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The outcomes of these reports were at best inconclusive and at worst contradictory with regard to the CAPCO program.

It is also notable that Section 620.1300, RSMo 2000, requires the State Auditor's Office to conduct a cost benefit analysis to evaluate the effectiveness of all programs operated by the DED. These reports are to be published every two years and submitted to the Governor and leadership of the General Assembly. The SAO is currently in the process of evaluating DED's programs.

I hope we have adequately addressed the comments of the Oversight Division. If you have questions, please contact my office at 751-4770 or Stacey Hirst, Manager of the Office of Business Finance, at 526-1558.

Very truly yours,

A handwritten signature in black ink that reads "Joseph L. Driskill". The signature is written in a cursive style with a large, looping initial "J".

Joseph L. Driskill

JLD:sh

c: Dennis Roedemeier
Stacey Hirst
Arlan Holmes
Khristine Heisinger

State of Missouri

Bob Holden, Governor

Department of Insurance
P.O. Box 690
Jefferson City, Missouri 65102-0690



Keith A. Wenzel
Director

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JAN 17 2001

OVERSIGHT DIVISION

January 16, 2001

Committee on Legislative Research
Oversight Division
Ms. Jeanne Jarrett, CPA, CGFM, Director
Room 132 State Capital
Jefferson City, Missouri 65101-6806

RE: Certified Capital Tax Credit Program

Dear Ms. Jarrett:

Per your letter dated December 28, 2000, the Department of Insurance is submitting the attached response to the two issues raised in the CAPCO evaluation.

If you have any questions regarding the information please contact Rochelle Paneitz at 526-2938 or myself.

Sincerely,

A handwritten signature in black ink, appearing to read 'Keith Wenzel', is written over the word 'Sincerely,'.

Keith Wenzel, Director
Department of Insurance

Insurance companies are allowed to utilize tax credits on amounts not invested in qualified Missouri businesses.

If an insurance company has already made the investment, the tax credit that may be taken later cannot be reduced. See 135.503.1, RSMo Supp 1999. Also, reduction of the CAPCO tax credit percentage is not MDI's responsibility. Section 135.503.1 places this responsibility on Economic Development with approval of the Office of Administration. The insurance company is an entity separate from the Certified Capital Company whose investments in qualified Missouri businesses is being questioned.

Section 135.503.1 authorizes a vested credit against premium tax liability of 10% of the investment in any taxable year. Insurance companies invest in the certified capital company. The certified capital company invests in the qualified Missouri business. Section 135.516 RSMo requires that at the end of two, three and four years they have invested 25%, 40% and 50% respectively. The insurance company has nothing to do with the certified capital company meeting or not meeting the investment schedule under 135.516 RSMo. It would seem unfair to penalize the insurance company for the failure of the certified capital company to meet the percentage of investment required. According to the Oversight report, \$48 million out of \$140 million had been invested in qualified Missouri investments as of June 30, 2000.

Even though section 135.503 authorizes the director of the Department of Economic Development with the approval of the Commissioner of Administration to reduce the applicable percentage on a prospective basis, the reduction does not affect credits already earned and vested. Since the premium tax credits were earned and vested at the time of the insurance company's investment in the certified capital company, the 10% credit could not be reduced.

The Department of Insurance does not reconcile the amount of credits it approves to the amount allocated to the General Revenue Fund and the County Foreign Insurance Tax Fund by the Department of Revenue.

In a technical sense, this reconciliation is not the Missouri Department of Insurance' responsibility. MDI's responsibility is only to certify the amounts of taxes. How tax receipts are divided into various government funds is the responsibility of the Department of Revenue and the State Treasurer. However, as long as it's not too burdensome, notifying Revenue per the procedure below is probably a good idea.

Three insurance companies sent in certificates for CAPCO tax credits and their 1998 premium tax was revised May 2, 2000. On July 26, MDI sent a letter to the Department of Revenue notifying them that additional CAPCO credits had been given against the 1998 premium tax return in a total amount of \$90,700. Section 148.350 requires that CAPCO tax credits only reduce general revenue portion of premium tax, not the county foreign split. On July 28, 2000, the Department of Revenue notified Jill Hansen at the State Treasurer's Office to transfer \$45,350 from general revenue to the county foreign insurance tax fund.

Insurance companies can amend their tax returns and receive refunds of tax overpaid for up to two years from payment of a tax. The final 1998 tax was due June 1, 1999 and can be amended until June 1, 2001 for a refund of tax.

The tax supervisor has instructed the tax accountants to notify DOR whenever amended returns are filed for additional CAPCO tax credits. MDI will request a listing of CAPCO tax credits from IS for the current tax year each June, December and April to forward to the Department of Revenue.

BOB HOLDEN
GOVERNOR



CAROL RUSSELL FISCHER
ACTING DIRECTOR OF REVENUE

MISSOURI DEPARTMENT OF REVENUE
POST OFFICE BOX 311
JEFFERSON CITY, MISSOURI 65105-0311
PHONE: (573) 751-4450
FAX: (573) 751-7150
WEBSITE: www.dor.state.mo.us

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JAN 23 2001

OVERSIGHT DIVISION

January 22, 2001

Ms. Jeanne Jarrett, CPA
Director
Oversight Division
Room 132, State Capitol
Jefferson City, MO 65101-6806

Dear Ms. Jarrett:

Please find below the Department of Revenue's response to the Division of Oversight's recent evaluation of the Certified Capital Credit program within the Department of Economic Development.

OVERSIGHT DIVISION RECOMMENDATION

Oversight recommends that the Department of Insurance and the Department of Revenue create and implement a system that would allow for periodic reconciliation.

DEPARTMENT OF REVENUE RESPONSE

The Department of Revenue receives information from the Department of Insurance and, consequently, has no way to perform a periodic reconciliation. However, the Department of Revenue will make every effort to work with the Department of Insurance to develop internal procedures to ensure accurate information is provided to the Department of Revenue.

Ms. Jeanne Jarrett, CPA
January 22, 2001
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Please notify Kim Lauer, Administrator, Internal Audit, of the scheduled date for Committee discussion. If you have any questions or concerns related to the department's response, please direct your inquiries to Kim Lauer or me.

Sincerely,



Carol Russell Fischer

CF:BA:dkn

c: Stan Farmer
Kim Lauer
Ken Pearson
Brad Adrian