Rural Opportunity & Investment Coalition

COVID-19 Economic Recovery Plan:

Helping Rural Canadian SMEs Access the Capital They Need

2020 Pre-Budget Submission

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Recommendation

- In order to assist Canadians in rural communities recover from the economic impacts of COVID-19, the Canadian government should implement a Canadian Rural Investment Tax Credit (RITC) program to allow experienced private sector fund managers to raise and deploy private capital into growth-oriented small and medium-sized enterprises (SMEs).

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Introduction

COVID-19 has impacted Canadians from all walks of life, including those living in rural Canada. As the economy safely reopens in the coming months, an economic recovery plan for business owners in rural Canada is urgently needed.

Rural communities face unique obstacles in growing their economies. Access to capital, challenges with multi-generational businesses, limited lending by banks or credit-unions and equity investors that concentrate on larger businesses in urban areas, strain SME growth in these communities. Simply stated, SMEs in rural areas lack the capital they need to grow and to recover from the economic impacts of COVID-19.

The Rural Opportunity and Investment Coalition (ROI Coalition) brings together public and private-sector stakeholders to advocate for policies that will help rural communities grow the job-creating businesses that support the local economy.

Overview of the Canadian Rural Jobs Investment Program

Modeled on the U.S. Federal New Markets Tax Credit (NMTC) program and programs created in a number of U.S. states, the proposed RITC program directs private sector fund managers to compete to raise and deploy private capital into growth-oriented small businesses in Canada's rural communities. The program leverages a delayed federal tax credit that can be withdrawn by the government if certain conditions are not met. The private capital leveraged through the tax credit must be deployed in the program's first three years, but no tax credits can be claimed during that three-year investment period.

US lawmakers are utilizing the NMTC program to help the economy recover from COVID-19. Recently, the Democrat-controlled US House of Representatives passed a stimulus bill which included a provision that would make the federal NMTC tax credit a permanent part of the tax code. Further, Democratic Presidential candidate Joe Biden has proposed to expand the NMTC program and make it permanent.

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<u>How It Works</u>

- **Step 1:** Private sector fund managers apply to a government entity to become an approved Canadian Rural Business Investment Fund.
    - Applicants are scored through a competitive process and would have to meet high-level qualifications.

- **Step 2:** Approved fund managers are required to raise private sector capital within a prescribed amount time.
    - Approximately half of the capital would leverage participation from investors seeking a tax credit and the remaining capital would come from traditional investors who do not receive a tax credit in exchange for their investments, but a traditional return on investment. Fund managers would be required to invest their own equity.

- **Step 3:** Fund managers would be required to deploy their capital into qualified small businesses in rural parts of Canada within three years.
    - Failure to fully invest the approved amount of capital would prohibit fund investors from claiming tax credits.

- **Step 4:** Tax credit investors would be able to claim 1/3 of their total tax credits over a three-year period (See Figure 1). Failure to meet program compliance criteria would trigger claw-back of the tax credits.

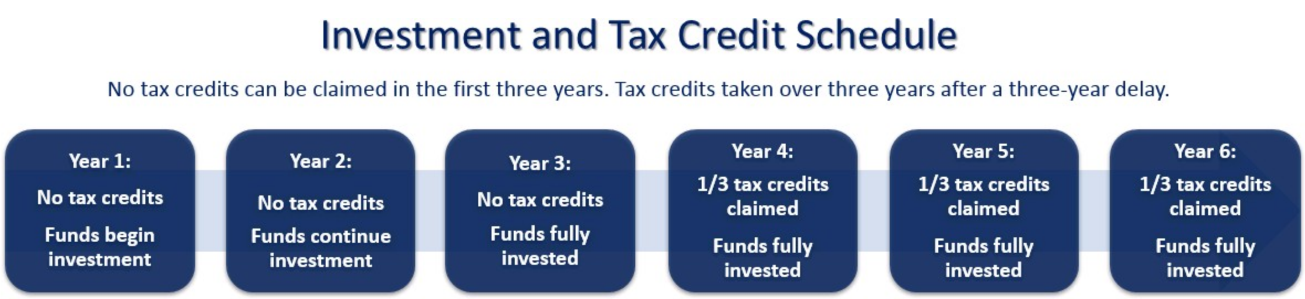

Figure 1

- **Step 5:** Full investment authority must be maintained through the end of the sixth year of the program.
    - Funds are required to maintain 100% of their approved capital invested in qualified small businesses. None of the approved capital can be used to pay management fees, distributions, or any other expenses.
- **Step 6:** At the end of the sixth year, funds that have complied with program requirements can exit the program and unwind their investments.

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Results from U.S. Federal New Markets Tax Credit Program (NMTC)

The U.S. federal NMTC program was signed into law by President Bill Clinton to encourage private sector investment in designated low-income communities. The program allows private sector entities to enter a competitive application process to be awarded an allocation of federal tax credits that are leveraged to raise and deploy private capital into businesses or organizations located in or serving low-income communities. It continues to have bi-partisan support in the U.S.

- According to the U.S. Treasury Department agency that oversees the federal NMTC program:
  - "Historically, low-income communities experience a lack of investment, as evidenced by vacant commercial properties, outdated manufacturing facilities, and inadequate access to education and healthcare service providers. The New Market Tax Credit Program (NMTC Program) aims to break this cycle of disinvestment by attracting the private investment necessary to reinvigorate struggling local economies."[1]

- According to the Community Development Financial Institutions Fund (CDFI), the NMTC program[2]:
  - Generates $8 in private activity for every $1 invested by the Federal government in tax credits.
  - "Since 2003, the NMTC Program has created or retained nearly 750,000 jobs. It has also supported the construction of 84.6 million square feet of manufacturing space, 62.7 million square feet of office space, and 42.7 million square feet of retail space."

[1] U.S. Department of the Treasury Community Development Financial Institutions Fund website: https://www.cdfifund.gov/programs-training/Programs/new-markets-tax-credit/Pages/default.aspx
[2] New Markets Tax Credit Program Fact Sheet: https://www.cdfifund.gov/Documents/NMTC%20Fact%20Sheet_Jan2018.pdf

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<u>Canadian Rural Investment Tax Credit Explanation of Contributions & Returns</u>

A common question that arises is how do funds unwind after they are successful? In other words, who gets what, and when? The section below details the "waterfall" of benefits from the RITC and the timing of those benefits.

Explanation of Contributions to Individual Funds

- Tax Credit investor (TCI): ~50% of capital for 6 years
- Non-tax credit investor (NTCI): ~45% of capital for 6 years or until the jobs requirements are met (whichever is later)
- Fund Managers (FM): 5% of capital for 6 years or until the jobs requirements are met (whichever is later)
- Canadian Government: (CA): Promise of future credits, subject to recapture, that are claimed in years 3-6 (only if investment conditions are met)

Return "Waterfall" (i.e., the order, form, rate and timing of returns and to whom)

1st in line: CA
Return form: Tax Revenue
Amount: Full cost of credits + 100% of excess revenue (no payments to funds for high returns or performance)
Timing: Begins with first investments; continues beyond the life of the program

2nd in line: TCI
Return form: Tax Credit
Amount: Equal to Principal + yield of 3-4% (estimated)
Timing: Years 3-6

3rd in line: NTCI
Return Form: Principal + Profit
Amount: Principal (if not lost due to risk) + first profits (if any)
Timing: Years 6 + or after jobs targets met, whichever is later

4th in line: FM
Return Form: Principal (10% contrib.) + Carried Interest
Amount: Principal investment (if not lost due to risk) + remainder profit (if any after NTCI)
Timing: Years 6 + or after jobs target met, whichever is later

In the Event of an Extraordinary Return: CA Profit Sharing
Return Form: Profit
Amount: 10% of yield above 20% internal rate of return (IRR)
Timing: Years 6+ whenever IRR exceeds 20%

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Best Practices Included in the RITC Policy

The ROI Coalition proposal takes the form of a rural investment tax credit that is based on policies developed in many U.S. jurisdictions over the past 30 years. The U.S. and state governments have pursued various tax incentives to assist capital formation for small to medium enterprises (SMEs) amounting in billions of dollars of capital investment. One of these various types of incentives is a **"fund-level" credit**, where a fund leverages an incentive to raise capital and, in turn, invests the capital in multiple small businesses (Figure 2). The RITC follows this approach.

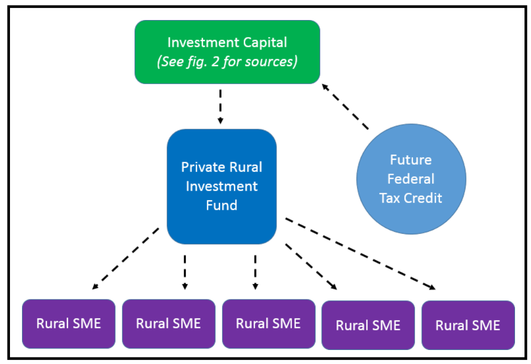
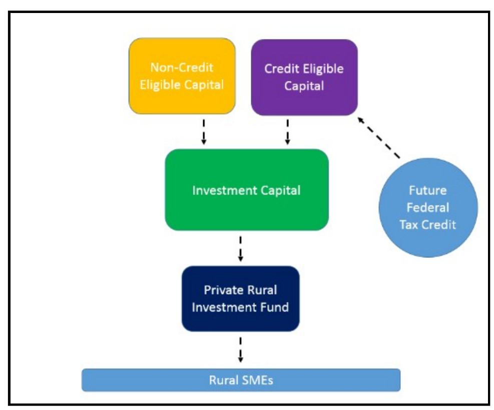


Figure 2

This approach is distinguishable from "business-level" credits that are earned directly by an SME or "angel credits", sometimes called "qualified venture" credits that are earned by investors but directly arise from an investment in a single SME. As a fund-level credit, the RITC spreads risk and return across a portfolio of SME investments, greatly broadening the type and range of investors who are drawn into the fund.

The next element that is critical to proper execution of an RITC is the **marriage of credit-eligible investments with non-credit eligible investments** in a way that assures full commitment from both sources. To explain, the RITC provides Canadian investors the opportunity to invest in funds and receive a dollar-for-dollar credit in exchange that can only be claimed at least three years after the investment. Those tax credits are contingent on approximately half of the remaining fund's capital from traditional investors, who invest capital without receiving a tax credit. Funds are required to invest their own capital so that all interests are aligned: the fund's interests, the investors' interests and the Canadians' interests. (Figure 3)



Further, the credits are clawed back if all capital raised by the funds is not invested into qualified SMEs within a specific time period and **maintained as fully invested for a long time period**. In short, if an RITC fund falls short of the investment objectives, there would be **no cost** to the government and all credits would be cancelled and/or clawed back from investors.

Another benefit of a multi-year commitment of private capital is the availability of **long-term, patient growth capital available to SMEs.** The funds will serve as sources of patient, growth capital to rural SMEs.

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All private capital must remain invested in the SMEs for six years, or the tax credits can be recaptured. If capital is repaid to a fund by a recipient SME, the fund must reinvest the returned capital into another SME with no new tax credits issued. In addition to providing capital, the funds will work closely with the SME, serving on their boards, mentoring entrepreneurs and assisting the companies in any way to grow and create jobs in rural communities.

Another key component is that, prior to the sixth year, funds cannot take **distributions or fees that would reduce the total amount invested in SMEs below the fund's authorized amount**, thereby aligning the interests of the funds, government, taxpayers, SMEs and investors.

Numerous safeguards exist to ensure that old, programmatic flaws do not continue to be utilized. These safeguards *do not exist* in similar, competing programs.

- ✓ Qualifications and competitive application process to ensure experienced fund managers participate in the program
- ✓ An up-front demonstration of private capital commitment to ensure that the funds can raise the necessary amount of private capital prior to investing
- ✓ Job creation and retention metrics to ensure that the program produces SME growth *and* job growth for rural communities
- ✓ Strict recapture provisions to ensure that the tax credits cannot be claimed against the federal budget until all programmatic requirements are met
- ✓ Strict penalty provisions to hold the non-tax credit investors and funds accountable to ensure that every program participant has a stake in the positive impact of the program
- ✓ Annual reporting requirements so that the government can account for and measure the SME, jobs, wages and other impacts from the investments
- ✓ Different sources of capital (all outside, non-self-leveraged private capital) to ensure an alignment of interests from all program participants: the funds, investors and government
- ✓ Strict standards to ensure that all of the private capital is utilized for SME growth – not for fees, taxes or other costs of a fund

<u>**Though alternative models may exist to insert private capital into targeted areas and businesses, none, if any, include the strict, transparent and sound safeguards of the rural investment tax credit.**</u>

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For more information:

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