The Certified Capital Company Program: A White Paper Review
The CAPCO Program

Introduction

The Certified Capital Company (CAPCO) program is a state economic development tool designed to encourage the local growth of small businesses and the formation and support of a local venture capital infrastructure. A CAPCO program allows insurance companies to invest in Certified Capital Companies (CAPCOs). States attract investments in CAPCOs by allowing insurance companies to claim tax credits for qualified investments into certified CAPCO funds. The State tax credits, taken over time, generate large pools of private venture capital to be invested in that state. CAPCOs, typically venture capital groups with significant local knowledge and industry expertise, leverage the funds received from insurance companies to invest in qualified small businesses in the state.

Recognizing that small businesses are a significant driver of job creation in the economy, states create CAPCO programs to address the unique challenges of small businesses in raising capital. Unlike traditional government assistance programs, the CAPCO program relies primarily on the private sector to invest in the targeted geographies or industries. By providing access to capital for early-stage businesses, CAPCOs promote entrepreneurship and serve as a catalyst for small business growth. While uniquely positioned to leverage private resources, CAPCOs are different from traditional venture capital firms and are best examined and evaluated as an economic development instrument. The participation in returns to the CAPCO managers is greater than the participation ratio typically associated with a traditional venture capital structure in order to compensate for the greater risks and internal rate of return compression associated with economic development mandates. The anticipated impact of the CAPCO program is the creation of new jobs and an increase in state and local tax revenue, with minimal initial investment on the part of the state. A by-product is business expansion through follow-on investment and the development of a venture capital infrastructure.

Several states have established CAPCO programs. In 1983, Louisiana became the first state to adopt a CAPCO-type program to encourage venture capital funding of small businesses in the state. Missouri, New York, Florida, Wisconsin and, most recently, Colorado and Texas have since enacted CAPCO programs.

Trends in Economic Development

Over the last 20 years, there has been a fundamental shift in state economic development policies. Traditionally economic development initiatives focused primarily on the attraction of large-scale manufacturing projects. States and localities often engaged in a highly competitive bidding process for high-profile manufacturing projects, where direct project subsidies and tax abatements could significantly influence facility decisions. Typically, this process resulted in a sizeable front-end investment by the community.

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Notable examples include Alabama’s $153 million package to attract a major automotive plant and its 1,500 jobs, at a cost of $161,000 per direct factory job and Pennsylvania’s $429 million package in support of a major shipbuilding project in South Philadelphia. While there is certainly a role for such assistance, it has been less effective in spurring sustained local growth for small and medium-size businesses.

As an alternative to direct subsidies, some states have attempted to spur investment activity by creating a business-friendly environment through the enactment of tax credit programs, lower or exempted taxes, and introducing direct business assistance initiatives. An example of these policies includes property and sales tax exemptions for manufacturing property that are common in many states.

With the growth and promise of the technology and small business sectors, states are shifting resources to attract high-growth service and technology based industries. Not surprisingly, recent industry fluctuations have stressed the need for a diversified economy. Business retention has once again become a top economic development priority, with incentive programs expanded to reward growth by existing businesses. Economic development policy increasingly recognizes the value of creating long-term quality jobs in a community, regardless of the source. Increased emphasis has also been placed on sustainable development programs that support economic viability over the long run.

Despite its vital role in economic development, the small business community has historically not benefited from meaningful state incentive programs. Small businesses typically do not satisfy the incentive program eligibility criteria, which require a minimum investment or job creation threshold. For those small businesses that may qualify for incentives, the transaction costs often negate any potential benefits. As an alternative, small business growth is targeted through initiatives designed to increase the availability of venture capital.

**What is Venture Capital?**

The venture capital industry provides money for start-up, early-stage or expansion-stage companies and small businesses with significant growth potential. Using pooled money from investors, venture capitalists create funds that invest in promising companies in exchange for a desired return. Venture capital firms reduce their overall risk by creating a portfolio of investments in several companies. For this reason, the recipients of venture funding are termed “portfolio companies.” This portfolio will vary in stage, industry and geographic location. Venture capital is not a passive investment, however. In addition to financial assistance, venture funds provide ongoing technical assistance in the development and management of the portfolio companies.

The first step in the venture capital process is the creation of the venture capital fund. To create a fund, venture capital firms seek to gather pools of capital from several diverse sources. A venture fund is typically structured as a limited partnership, with a general partner and several limited partners. In contrast to the numerous responsibilities of the
general partner, the limited partners typically only contribute capital for the venture fund. Typical limited partners include institutional investors, pension funds, banks, foundations and wealthy individuals with the number of limited partners dependant upon the target size of the venture fund. Each limited partner receives the right to disbursements in proportion to its capital contribution to the fund and after the venture firm raises sufficient capital for its fund, the venture fund is closed to additional investment.

Once the venture fund is formed, the general partner then coordinates the selection of the portfolio companies. The selection of portfolio companies may depend upon the objectives of the venture fund or the competencies of the fund managers. For example, a venture fund may select portfolio companies within an industry, driven by the expertise of the venture fund partners. In addition, some venture funds may favor investing in companies during one of several stages of development. A venture fund may provide “seed capital” to a company that has yet to begin operations or invest in companies in the initial stages of product development. A developing business may seek expansion or “mezzanine” financing from venture funds to assist with market delivery or deployment or later stage financing may assist a mature company prior to its initial public offering (IPO). These stages of development are subjective criteria with no set investment thresholds. In practice, the stage and pace of growth may vary for portfolio companies within the same fund. Selecting from a pool of applicants, each venture fund invests in a limited number of portfolio companies. Portfolio companies use this investment to fund the growth and development of their business.

Unlike bank and “angel” assistance, venture funding requires hands-on involvement from its general partners and thus adds another layer of value. Upon the selection of portfolio companies, the general partner assumes liability and management responsibility over the portfolio companies. To cover these costs, the general partner charges a management fee to the fund’s limited partners. The typical management fee ranges from 2 to 2.5 percent.² In return for increased risk, the general partner in a venture capital fund receives shares of the investment in the portfolio company, referred to as “carried interest.” Through the management and technical expertise of the general partner, the venture capital fund attempts to increase the value of its investment. The venture fund receives a return on its investment through a “liquidity event” such as an IPO, merger or acquisition. Once a liquidity event occurs, the proceeds from the fund can be reinvested or distributed. Investing in a venture fund is a long-term investment, since the elapsed time from initial investment by the venture fund to the eventual disbursement of proceeds may be as many as seven to ten years. Venture capital requires a liquidity event before the process can begin again. Because of this, the general partners dedicate considerable resources to the evaluation of portfolio companies.

Although venture capital funds may invest in portfolio companies in several industries, many venture capital funds specialize in certain industry sectors. In order to reduce their risk, venture capital firms often focus on geographic markets with a critical mass of potential recipients. Consequently, venture capital investment has often been

concentrated in certain regions with industry clusters. For instance, venture capital funds focusing on technology are most prevalent in the San Francisco Bay Area market. The likelihood of obtaining venture capital funding rests upon building relationships between prospective funding recipients and the venture firms. In general, venture capital firms employ local experts with knowledge of the regional market. As such, a local presence in venture funds is often essential. Start-up businesses are discouraged from locating in areas outside of industry clusters because of their need for access to the venture capital market. Existing early stage companies often reach a critical stage in their development process, where venture capital can enable continued growth. Without access to necessary financing, small businesses are more likely to relocate to a preferable location or stop growing. Financing becomes a critical factor for survival and sustained business growth. Greater availability of financing may facilitate small business growth and economic development.

**Relationship between Venture Capital and Economic Development**

The economic impact of the 24 million small businesses on the United States economy underscores that small businesses are the backbone of the US economy. Small businesses employ 69 percent of workers and create over 60 percent of new jobs in the United States. Moreover, small firms produce twice as many innovations per employee as their large firm counterparts. Additionally, small businesses provide increased opportunities for women and minorities. Yet, despite the economic benefits that flow from the success of small businesses, they rarely have access to sufficient capital.

Access to venture capital is essential to avoid stagnation of the small business community. In return for assuming the risk of investment, general partners of venture funds typically serve on the board of the portfolio company and become involved in the day-to-day operations of the company. General partners leverage their significant expertise and relationships to provide valuable management assistance to guide the development of their portfolio companies. Historically, venture capital has served a vital role in accelerating the growth process of numerous high-profile companies. Notable examples include such household names as Cisco Systems and Amazon.com. In fact, one in four companies from *Inc.* magazine’s annual list of 500 fastest-growing companies began with an investment of under $5,000. Most of these companies leverage the venture capital investment to build thriving businesses that contribute significantly to regional economic development. Throughout their expansion, the portfolio companies create increasing employment opportunities, as well as tax revenues. With the current uncertainty in the U.S. economy, the availability of venture capital funding has become increasingly scarce and competitive.

Recognizing the important role of venture capital in economic development, numerous states have undertaken targeted economic development efforts to encourage venture

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capital investment. As a method of encouraging private sector investment in a targeted activity, tax credits are desirable because they do not require direct governmental investment yet induce the desired activity. Unlike negotiated incentives, tax credits provide comparable benefits to similarly situated taxpayers. This transparency and predictability allows taxpayers to rely upon the credits to reduce their costs.

An example of a successful investment tax credit includes the federal Low-Income Housing Tax Credit (LIHTC). By offering tax credits to low-income housing developers, the LIHTC has grown to become the largest federal program for affordable housing. The LIHTC has made steps towards alleviating the low-income housing shortage that prompted the inception of the credit in 1986. One particularly attractive feature of the LIHTC is the deferred impact on the U.S. Treasury, due to the 10-year period over which the credit is claimed. Similar in cost and structure to the CAPCO program, the federal LIHTC is a 90% credit taken at a rate of 10% per year. The economic relationships between the developer and the manager are negotiated privately.

As evidence of the success of these programs, similar state tax credits have been adopted using the federal credits as a model. A number of states have enacted income tax credits for taxpayers making direct investments in venture capital. By encouraging investments in venture capital, the tax credit programs aim to increase the level of venture funding available to small businesses. A precondition of private sector investment in venture capital is the existence of adequate venture funds or qualified individuals interested in fund organization. As mentioned, venture funds typically invest in a number of portfolio companies. However, the formation of a venture fund requires a significant upfront expenditure that would not be made without a sufficient supply of eligible portfolio investments. Without a critical mass of potential portfolio companies to justify the formation of venture funds, investment in venture funds may remain low. Programs that encourage the formation of venture funds attempt to break the vicious cycle.

The Role of CAPCOs in Economic Development

By encouraging the creation of CAPCOs, states directly address the barriers to venture capital investment. CAPCO’s are generally required to invest in non-bank small businesses located within the state, with limits on revenues and number of employees. Unlike other venture capital funds, the CAPCO program is structured in a way that encourages in-state capital formation and fosters local business growth. CAPCOs face multiple restrictions on their activities and are required to balance strictly market-based investment decisions with the equity and growth objectives set by states.

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5 I.R.C. section 42.

6 See General Accounting Office, Tax Credits: Opportunities to Improve Oversight of the Low-Income Housing Program 2 (1997).

For numerous legal and practical reasons, the benefits of the CAPCO program have generally been restricted to insurance companies. As mentioned, insurance companies are a significant source of investment funds and are subject to premium tax, or a tax on the receipts from premium received, in every state. Because the insurance companies typically pay premium tax in lieu of income taxes, they generally do not benefit from income tax credits. In order to encourage insurance companies to invest their considerable cash reserves in state-restricted venture funds, states included the premium tax credits as a key component of the CAPCO program.

A premium tax credit is unique due to the consistent nature of premium taxes, which are less prone to year-to-year fluctuation than income tax credits. While predicting taxable income in future years can be difficult, insurance companies may easily estimate the future receipts upon which their premium tax will be based. As a result, states can predict with increased accuracy the fiscal impact from a credit against premium tax. Because of the greater certainty of the premium tax credit, an insurance company is more likely to factor the value of the credit into its investment calculations. Because insurance companies are sophisticated long-term investors in fixed-income investments, the premium tax credit enhances the expected return and encourages participation in the CAPCO program. For these reasons, states may derive more predictable economic development benefits from a premium tax credit for investments in CAPCOs than from a credit claimed against income tax. The premium tax credit for CAPCO investments directs funding that would otherwise not have been invested into the newly formed venture funds.

CAPCOs differ from some state venture fund programs in that capital is not allocated through a government agency yet is specifically limited to investments within that state. In fact, the state does not direct any of the CAPCOs’ investment decisions, and require that those be made strictly on the basis of each manager’s investment judgment. The active role of the state in the process is generally limited to rule-setting and monitoring.

CAPCOs operate as a competitive private sector mechanism to channel capital from insurance companies to growing early stage companies in need of assistance. By relying upon private sector financing, the CAPCO program provides venture capital through several CAPCOs working independently. In an attempt to maximize profits, CAPCOs compete with one another to raise funds and support the most promising companies in need of financing assistance. The process is competitive and potential recipients apply for funding through one of several CAPCOs that have been established. By providing funds to only the most promising applicants, the CAPCO program validates the return potential of the portfolio companies. This facilitates the ability of portfolio companies to leverage their funds to obtain subsequent rounds of financing. Once a CAPCO investment is made, the information necessary to obtain supplemental venture funding is more readily available and follow-on funding is likely.

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Ultimately, the economic development effects of a successful CAPCO program are threefold: 1) CAPCO increases direct venture investment in a region; 2) the CAPCO investments have a multiplier effect on additional venture capital investments; and 3) the prospects for growth of the portfolio companies are enhanced. The state may profit directly from the CAPCO program as well. In Florida and Colorado, for example, the state receives a percentage of profits from CAPCOs.9 Most significantly, the state benefits through new jobs and tax revenue.

In other words, the overriding objective of the CAPCO program is economic development. It is important to remember this objective because it has an effect on how CAPCOs are evaluated and how overall success is measured by the state. The ultimate purpose of a CAPCO investment is not simply profit generation for the state, although some states do take advantage of the profit generated from the process. By instituting a CAPCO program, states seek benefits much broader than venture capital profit. As those familiar with economic development know, these broader benefits are both more meaningful for a state’s long-term economic well-being and extremely difficult to quantify or attribute to one specific program.

CAPCOs are not simply a source of cash infusions for early-stage companies. They allow states to support business growth in a hands-off manner, by bringing management skills and expertise to each CAPCO-supported company, and by exercising investment and administrative oversight. Thus, while the state does have a significant financial stake in the process through the premium tax credit, the CAPCO program allows the state to avoid day-to-day management and oversight resources, and to support high-risk investment activities while being protected from the traditional downsides associated with venture capital investment.

Much like other economic development programs, CAPCO programs require that program recipients have the majority of their employees in the state.10 CAPCOs act as funders of last resort in that they typically support companies that would not be immediate funding targets for traditional venture capital firms. CAPCOs face numerous restrictions and requirements with respect to eligible companies in part to ensure that the CAPCO resources are spread equitably among as many potentially viable recipients as possible and that the CAPCO investment efforts reach areas targeted for economic development by the state. Understandably, the risk-return profile for a CAPCO is therefore different than it would be for a traditional venture capital firm.

All programs seek to directly benefit the enacting state. A significant percentage of the portfolio company employees must be located in the state at the time of investment to be a qualified business.11 To further implement their economic development mandate, states may adopt requirements that portfolio companies be members of a certain industry or region. Texas is an example of a state that requires that 50 percent of the CAPCO

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investment be allocated to early stage companies and 30 percent occur in certain geographic areas, termed “strategic investment areas.”\textsuperscript{12} Through these requirements, states ensure that the economic development benefits are targeted to priority businesses in their region.

\textit{CAPCO Structure and Return Profile}

A CAPCO is generally made up of a venture capital firm as the general partner or controlling shareholder, with insurance companies as limited partners or minority shareholders. Insurance companies are usually restricted from owning above a certain percent of the CAPCO, being affiliated with the CAPCO or serving in the general partner capacity.\textsuperscript{13} To become a CAPCO, an application typically must be filed with the administering agency. The barriers to entry of the CAPCO program are relatively high due to the experience requirements, the high costs associated with participation and the complex structure of a CAPCO. In order to participate, a potential CAPCO must demonstrate that it possesses the necessary resources to effectively provide venture capital assistance. Approved CAPCOs must also demonstrate their significant experience with venture capital investments and sufficient financial resources.

To serve its portfolio companies, a CAPCO must also maintain a local office in the state.\textsuperscript{14} Although CAPCOs receive a 2.5 percent annual management fee, typically the management fee is allocated to expenditures associated with the salaries and overhead of establishing an office of quality investment professionals. For example, the new CAPCO must lease office space, spend money to purchase furniture and office equipment and hire investment professionals and administrative help. These costs may run very high and often exceed the income collected as management fees.

By instituting a CAPCO program, the state does not bear any risk for the quality of the subsequent investment activity.\textsuperscript{15} CAPCOs are required to include a disclaimer on their investment prospectuses that explain that CAPCO investments are not government obligations.\textsuperscript{16} However, the success of the CAPCO program depends upon the attractiveness of the investment and stability of the participating CAPCOs. To provide for adequate capitalization of CAPCO investments, states have established requirements governing distributions. In general, disbursements of gains are only permitted to the extent that sufficient capital investments have been made by the fund over and above the level of authorized tax credits.\textsuperscript{17} Disbursements of capital may not otherwise be made until the CAPCO has placed investments of at least 100 percent of the certified capital (capital upon which tax credits may be claimed) into qualified portfolio companies.\textsuperscript{18}

\textsuperscript{12} Tex. Ins. Code Ann. art. I, § 4.56(B).
\textsuperscript{13} See, e.g., Wis. Admin. Code Comm. § 111.04(3).
\textsuperscript{14} See, e.g., N.Y. Tax Law § 11(a)(3).
\textsuperscript{15} See, e.g., Wis. Admin. Code Comm. § 111.04(1).
\textsuperscript{17} See, e.g., Colo. Rev. Stat. § 10-3.5-108(1).
\textsuperscript{18} See, e.g., Wis. Stat. Ann. § 76.560.36(3).
Once a CAPCO has fulfilled its investment requirements, the CAPCO may voluntarily decertify and distribute its investment to its shareholders without triggering credit recapture provisions.¹⁹

To encourage participation by the regulated insurance companies, the structure of the CAPCOs works to minimize the limited partners’ exposure to risk. Of the money invested in a CAPCO, a certain portion is available for financing of qualified portfolio companies and a portion of the funds is invested into low-risk securities, such as U.S. Treasury notes. Very often, rather than offering only equity investments that may represent an inappropriate level of risk for regulated insurance companies, CAPCOs agree to provide a note with a fixed rate of return to the limited partners in addition to an equity component. Additionally, a CAPCO is often structured to offer credit enhancement insurance to enable it to repay the insurance companies if it is unable to qualify for the tax credit benefit. By providing an insured rate of return, CAPCOs demonstrate the security of the investment to both the insurance companies and their regulators. CAPCOs typically do not profit from the program until their investments or portfolio companies mature and have a liquidity event. Consequently, proceeds from a liquidity event in the early investments of CAPCOs are put back into the venture fund and recycled to fulfill the 100 percent investment requirement. Therefore, a CAPCO, in order to reap any profits or benefits from the CAPCO program, must make prudent investments within well defined limitations set forth by the regulations of the state and ensure the success of the portfolio company through a liquidity event. Only the proceeds of the portfolio company investments are reinvested into additional portfolio companies. The typical time horizon for distributions is three to seven years from program inception.

New York provides an example of the CAPCO investment milestones. Within two years of the certification of the CAPCO, a CAPCO is required to invest 25 percent of its capital in qualified companies. Within three years, the investment percentage increases to 40 percent, and after four years from certification, a CAPCO must invest at least 50 percent of the capital in qualified companies and a CAPCO must invest 100% of its certified capital before any profits can be realized.²⁰ By establishing phased-in investment thresholds, the CAPCO program balances the need for expedited investments of venture capital with the realities of the portfolio selection process. The proceeds from qualified investments may count towards the threshold investment requirements, effectively rewarding CAPCOs for realizing early profits.²¹

Additional safeguards exist to minimize the risk to insurance company funds and maximize the economic development benefits. CAPCOs must abide by a diversification requirement, which generally prohibits initial investments of more than 15 percent of the total capital in any portfolio company.²² Furthermore, CAPCOs often obtain reinsurance by hiring an independent insurance company to guarantee a certain return to investors.

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¹⁹ See, e.g., N.Y. Tax Law § 1511(k)(5)(D).
²⁰ N.Y. Tax Law § 11(c).
²¹ See, e.g., Wis. Admin. Code Comm. § 111.06(2)(b)(2).
Each state provides oversight of the CAPCO program to further reduce the risk of participation. In Florida, the Office of Tourism, Trade and Economic Development (OTTED) is charged with administering the CAPCO program. Shortly after the program’s inception, OTTED established comprehensive regulations for the application and compliance process.\(^{23}\) In addition to a strict financial review of its applicants, OTTED requires applicants to have at least one full-time manager with venture capital experience located in the state.\(^{24}\) Florida CAPCOs are also required to agree to disbursement standards.\(^{25}\) OTTED conducts an annual review of each CAPCO to determine whether it adheres to the program requirements.\(^{26}\) To offset a portion of the administrative costs, OTTED levies an initial application fee and annual user fees.\(^{27}\) Failure to comply with the program standards may result in a forfeiture of all future premium tax credits as well as a recapture of all premium tax credits previously claimed.\(^{28}\) When combined with OTTED oversight, this measure has resulted in compliance by each of the approved CAPCOs.\(^{29}\) These investor protections also reduce the risks for insurance companies participating in the CAPCO program.

**Program Duration**

The duration of a typical CAPCO fund may vary significantly, based on its time frame for completion of the certification, portfolio company selection and disbursement processes. Upon satisfying the investment thresholds, the CAPCO may either reinvest the proceeds in portfolio companies or distribute the funds to its partners.

The level of interest from the venture capital and entrepreneurial community has outpaced the allocation of CAPCO credits. To meet the demand, states have renewed the CAPCO program through additional allocations of CAPCO credits. For instance, Missouri’s CAPCO program became effective in 1997 with an initial allocation of $50 million in tax credits. In 1998, Missouri expanded its CAPCO program with another $50 million in allocated tax credits. A third round of CAPCO credits were authorized in 2000.\(^{30}\) Other states have renewed their programs since their inception as well.\(^{31}\)

To minimize the fiscal impact from the premium tax credits, states typically require CAPCO investors to claim premium tax credits over a number of years. Typically, states allow the premium tax credit to be claimed at up to ten percent each year for ten years.

\(^{23}\) Fla. Admin. Code Ann. r. 3E-7.001 et seq.
\(^{27}\) See, e.g., Fla. Admin. Code Ann. r. 3E-7.004.
\(^{28}\) Id.
\(^{30}\) IC² Institute, p. 2.
\(^{31}\) See, e.g., N.Y. Tax Law § 11(h)(describes each of the three CAPCO rounds).
beginning in the year of the investment. Because the premium tax is collected in the periods following the collection of insurance premium, there is a one to two year lag between the collection and tax of premium. Due to the time value of money, the value of a one-dollar tax credit in 12 years may be approximately 55-65 percent of a credit of equal value claimed in the current year. The delayed fiscal impact of the CAPCO program allows states to defer the program’s expenses, with the intention that increased revenues through added jobs and tax revenues from business expansion as a result of the CAPCO program may offset its costs.

Small Businesses as the Targets of CAPCO

As mentioned above, small business is the primary driver of our nation’s economy. CAPCO programs often have specific eligibility requirements for portfolio companies. To ensure that CAPCO funds are used as seed capital, every state has adopted restrictions on portfolio company size. By focusing on small businesses as portfolio companies, CAPCO programs contribute to a favorable business environment for small business. The Small Business Association (SBA) has adopted size standards for qualified businesses. Rather than devise a potentially cumbersome requirement, states such as Florida and Colorado explicitly incorporate the SBA qualification into their CAPCO programs. On the other hand, Wisconsin restricts CAPCO investments to companies with no more than 100 employees, no more than $2,000,000 in federal income taxes as well as a net worth of no more than $5,000,000. Portfolio companies must also be independently owned and operated. Regardless of the particular requirements, the CAPCO program is geared towards investments in small businesses only. The type and range of investments depends upon the state.

To direct CAPCO funding to small businesses in need, states have enacted certain types of eligibility restrictions on the CAPCO program. For example, portfolio companies may typically not be predominantly engaged in professional services such as accounting, law or medicine. Real estate development firms may also not receive CAPCO funding in many states and CAPCOs may not invest in retail establishments. In addition to the above industries, Florida explicitly restricts CAPCO funding from businesses engaged in oil and gas exploration. These exclusions are based on the premise that these industries are motivated by their desire to serve customers in the local market. Because market-driven expansions will likely occur without incentives, the goal is to redirect the CAPCO program’s focus to those industries for which venture capital can positively affect

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33 13 C.F.R. § 121.201.
36 See, e.g., N.Y. Tax Law § 11(a)(6)(D).
retention and growth. The CAPCO program aims to foster the transformation of local businesses from small to regional, and ultimately national, in scope.

States may enact eligibility requirements to target CAPCO funding to recipients in key industries. For instance, Florida’s CAPCO program is restricted to companies in manufacturing, processing, research and development as well as providing services other than those that are excluded from participation. Florida also requires CAPCOs to invest 50 percent of their funds in early stage technology businesses, which includes businesses that are less than two years old and involved in “developing initial product and service offerings, such as prototype development or the establishment of initial production or service processes.” Similarly, Colorado’s new program requires that at least 25 percent of CAPCO investments be dedicated to rural areas. With these requirements, states can direct additional resources to address specific economic development priorities. Targeted regions or industries may benefit from receiving a relatively greater share of venture capital funding.

The CAPCO investments have a leverage effect on venture capital for portfolio companies. CAPCO funding is often a last resort for early stage companies and CAPCO programs may require that a portfolio company demonstrate its inability to secure traditional sources of financing. Thus, any growth by CAPCO portfolio companies represents growth that would likely not have otherwise occurred. CAPCO portfolio companies have improved access to supplemental capital, as their selection into the CAPCO program provides an increased comfort level for sources of conventional financing. In essence, CAPCO compounds the level of venture capital that may be available in a given area. By doing so, CAPCO helps a state produce a critical mass of venture capital funding for assisting other early stage companies.

The Future of CAPCO

New York originally enacted the CAPCO program with the purpose of directing “the investment of private financial resources into the State’s venture capital markets, emphasizing viable smaller business enterprises that traditionally have had difficulty in attracting institutional venture capital.” Since it authorized the initial CAPCO program with $100 million in authorized tax credits, New York has approved two subsequent funding rounds of $30 million and $150 million in authorized tax credits. Missouri and Louisiana have conducted multiple rounds of CAPCO certifications as well. In less than 10 years of the program’s existence and active use, the CAPCO program has gained momentum across the country with Colorado and Texas enacting their CAPCO legislation in 2001 and is being considered in a number of states for the upcoming year.

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44 N.Y. Comp. Codes R. & Regs. tit. 11, § 400.1.
45 N.Y. Tax Law §§ 11(h); 1511(k).
Now more than ever, small businesses need venture capital assistance to continue their growth. In general, there has been a precipitous slowdown in venture capital transactions and with the decline in IPOs attributable to market conditions, the liquidity events necessary for the venture capital cycle to renew itself have been delayed. In the absence of the influx of capital that would normally be available through an IPO, later stage companies require supplemental infusions of venture capital. As such, venture funding has been diverted from early stage companies to sustain the continued growth of pre-IPO companies. In negotiating the remaining deals, venture capital firms have curtailed their outreach efforts and retreated geographically to the industry hotbeds. Much like a community experiences exponential growth associated with an increase in venture capital, the effect of the declining availability of venture capital is compounded as well. The CAPCO program may provide a mechanism to stem the outward flow of venture capital.

Conclusion

The CAPCO program provides an economic development tool to enable states to encourage private sector investment activity in target industries. Because of the role of venture capital in the formation of developing industries, CAPCO programs may be used as a mechanism to cultivate small businesses in high-growth industries. The CAPCO program lends itself to modifications in response to industry trends and it provides a framework for states to foster local entrepreneurship. The CAPCO program provides states with a tool to address the priorities of the small business sector and their economic development programs.

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