Equity Tax Credits as a Tool of CED

A comparison of two local investment incentive programs

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In addition to seeking programs for outright grants from government, many community economic development (CED) practitioners have promoted provincial and/or federal tax credits as a way to attract financing from the private sector. Two provinces, Manitoba and Nova Scotia, have each enacted equity tax credit programs for CED purposes. Yet program uptake and outcomes in the two jurisdictions have been markedly different. What happened here? This article outlines and compares the design and implementation of the two programs, and then looks for the lessons these experiences have to teach us about the role equity tax credits can be made to play in CED.[1]

Nova Scotia

In 1992, a Nova Scotia citizens' advisory group recommended that the legislature promote business creation through the provision of tax incentives to community-based capital investment initiatives. The assurance of a tax credit would encourage Nova Scotians to back the entrepreneurship of their fellow citizens. The recommendation was enthusiastically accepted, and legislation was passed in 1993. However, the provincial Securities Commission found serious legal and risk problems in the way that the law assumed that community folk would promote investment by their fellow citizens. The Commission was afraid there wasn't sufficient protection for investors built into the operations of the community investment organizations. As a result, its original intent notwithstanding, the Equity Tax Credit program was designed and launched without a CED component. It provided merely for an individual's equity investment decision, not for community action. As such, ordinary citizens took little advantage of it.

In 1998, however, a dedicated provincial civil servant returned to the idea. He convened a work group from the Securities Commission, the Finance Department (the provincial budgetary agency), and the Department of Economic Development and Tourism. In short order they redesigned the legislation so as to meet the Commission's objections. The legislature swiftly passed their version, and the provincial Community Economic Development Division rolled out the new program.

Thus were launched in 1999 the first three Community Economic Development Investment Funds (CEDIFs) that raised in all about a million dollars for their projects. While some aspects of the program have since been tweaked, an eligible CEDIF in Nova Scotia then as today embodies the following features:

- It is a corporation, co-operative, or association (but not a charity or nonprofit) organized by citizens of a geographically defined community, with the aim of investing in business projects in that community.
- It may envisage investment in a single specified business project or in more than one. Alternatively, it may constitute itself as a "blind pool" for projects as yet unspecified.
- It may simply invest in the project, or it may operate the business in which it has invested.
- At least 25% of total wages must go to Nova Scotia residents.
- It must be controlled by community members through a 6-member, unpaid board of directors elected by all the investor/shareholders at annual meetings. (The members of the original board are ordinarily self-selected in order to market the initial shares to their fellow community members.)
- Any investment must be clearly an endeavour that is intended to produce a profitable income stream. In short, it cannot be simply a community benefit like a park.
- The individual investor must hold his stake for a minimum of five years in order to qualify for a 30% provincial tax credit.
- A CEDIF investment qualifies (is pre-approved) for a person's own RRSP. Thus, if entered as an RRSP contribution, the investment and any income from the investment is taxed only through RRSP procedures.

Among the later changes in the program was the elimination of a limited provincial guarantee against loss. The Province was prepared to reimburse investors the losses they suffered in excess of 80% of their original investments. However, this provision posed many difficulties in administration and was rarely invoked. So in consultation with the existing CEDIFs, the provision was dropped in favour of successive tax credits. That is, after the initial five years, if the shareholder's investment in the local CEDIF was rolled over for another five years, it would be eligible for an additional 20% tax credit; and if rolled over for a further five years, there would be an extra 10% credit. This provision took effect in July 2006, and has had the desired effect of sustaining the operations of most of the CEDIFs. Indeed,

[1] Québec also has tax credit provisions that foster CED, but we will not deal with them here because they differ so markedly in structure from those of Manitoba and Nova Scotia.

experience has borne out the function originally envisaged for them: that of enduring community tools. (Some Funds have floated as many as six successful offerings over several years for repeated expansions and enhancements of their businesses or for new businesses.)[2]

What is now labeled the Department of Economic *and Rural* Development initially receives and vets the applications of community groups for general review. The actual "due diligence" is the work of the Securities Commission. Ultimately, the Commission, if it is satisfied, issues a so-called "non-objection letter" that allows a CEDIF to finalize its shareholders' purchases. The provincial Department of Finance issues the tax credit eligibility letter and at the end of the 5-year term of the investment provides each shareholder with a tax credit voucher. Ordinarily, a community application ("Simplified Offering Document") submitted for initial review to the Department of Economic and Rural Development by October can with the Department's approval be forwarded to the Securities Commission, get reviewed, and receive the non-objection letter in time for RRSP eligibility within the same tax year. Almost all community applications try to follow this timetable.

The record of these initiatives is outstanding. At this juncture, ten years into the program, there are about 48 CEDIFs in operation in Nova Scotia. Over 4800 community investors have provided about $32 million in capital in over 90 successful offerings.[3] Only two CEDIFs have failed to date and one or two others are faltering. The rest are doing well. One Fund spun off its business and returned all the capital to its investors. Thus at the worst we are looking at a failure rate of about 8%, as compared with the 66% failure rate common to new businesses.

The outstanding record of this CED program no doubt has a lot to do with the fact that local people are putting themselves on the line with their friends, relatives, and neighbours in small town and rural settings where they are highly visible to each other. Consequently they are undoubtedly both diligent and conservative in their work. By contrast, apart from a successful initiative taken by the Halifax-based Black Business Community Investment Fund, the program has not had takers in the urban settings where proponents are ordinarily not so visible.

Note that all the investors are indeed local citizens, residents of the communities in which the businesses are operating. While corporations and banks, as well as people outside of Nova Scotia, would be accepted as investors, they would not be eligible for the Nova Scotia tax benefits. So the investment has less attraction for them. This is truly a community-based affair.

[2] Another change has been to eliminate a requirement that each CEDIF create a wide-ranging plan and strategy for the overall development of its community. Now planning activities need only focus on each Fund's particular business projects.

[3] A summary of the total numbers of CEDIFs, investors, and the amount of their investment to April 20, 2009 is available at "CEDIF Funds," *Nova Scotia Canada*, Nova Scotia Department of Economic and Rural Development. 3 November 2009 <http://www.gov.ns.ca/econ/cedif/funds>.

There have been no outside evaluations of the program. However, the standard government calculations used for business development models in Nova Scotia programs indicate that this program more than paid for itself within its first two years. It is no wonder that the CEDIF idea is held in high esteem in Nova Scotia circles.

There are some die-hards who insist that governments should do no more than offer loans, if that. It is true that the investment banks and brokerage industry didn't take well to the idea of government involvement in the investment field, especially as they do not get fees from this activity. But by this time they have probably resigned themselves to the situation. We understand that some representatives of the sector have even become community fund investors themselves.

What is the future of this approach? Over time the rate of CEDIF investment in Nova Scotia will no doubt continue to increase to some degree. But there is probably an annual ceiling on the investments that community folk can make. After all, there is an inescapable risk in launching new businesses and in requiring that the investments be local. By contrast, the venture capital sector typically cherry-picks wherever and whichever good opportunities present themselves. But Nova Scotia has demonstrated that community capital is in fact readily available and can be tapped for community development. And there are still many communities in the province that have yet to mobilize themselves for their own development.

Manitoba

In 2004, five years after Nova Scotia's CEDIF program, Manitoba established its own local investment tax credit. For many years prior, the Manitoba government had been supporting *rural* economic development with a Grow Bond program. It guaranteed the repayment of the principal that people invested in local rural enterprises. The rate of business failures under the Grow Bond program was high, however. The province had to make good on many guarantees and carry a constant liability for future losses on its books. Also, the Grow Bond program did not generate the intended dynamic of local development. Investors perceived their Grow Bond investments more as guaranteed investments than as risk-related investments in the local economy. Rather than work with an enterprise if it went on the ropes, investors often would sooner fold it and claim their repayment. Provincial officials found themselves doing much of the due diligence they had been hoping the investors would do.

In 2000 a new Director of Rural Economic Development Initiatives began to research alternatives to the Grow Bond. He was looking for an instrument that would encourage local investment for local development, that would ensure that investors carried out their own due diligence, that would motivate them to stay involved with each enterprise, and that would share

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risk more appropriately between Province and investors. He looked into community investment instruments across North America, including the Nova Scotia CEDIF tax credit.

In this way came into being the Community Enterprise Development Tax Credit, a program administered by the Manitoba Department of Agriculture, Food, and Rural Initiatives to encourage individual investment in local community enterprises. The program naturally has a rural slant. The Department has made no real effort to apply the program in urban areas (which for Manitoba essentially means in Winnipeg). Investors receive a 30% tax credit for investments in a government-approved community enterprise or in a CEDIF. They must maintain their investments for at least three years. Investment shares in co-operatives are eligible for the tax credit, as well as the standard stock investments in private enterprise.

To be eligible for the program a local enterprise must meet the following criteria:

- Gross assets under $25 million.
- Net assets under $10 million.
- 200 or less employees, of whom at least 25% reside in Manitoba.
- At least 25% of the organization's total wages must be paid to Manitobans.
- Sponsorship or endorsement from a local community development organization.
- Does not invest in certain commercial sectors, such as commercial property or seasonal recreational facilities.

Alternatively, a CEDIF itself may be eligible, but it would need to be organized primarily for the purpose of investing in community enterprises or in community development corporations. It would also need to be sponsored or endorsed by a person or group of persons from the community in which the corporation proposes to make investments.

Even though CEDIFs are included within the Act, Manitoba government officials indicate that they are highly unlikely to approve one. They are concerned that the administrative costs in managing a CEDIF may be prohibitive. They are also still experiencing strong repercussions from the failure of the labour-sponsored Crocus Investment Fund in 2005. They feel that government support for CEDIFs might be construed as support for another such initiative. No CEDIFs have applied to date. (In 2007 the legislation was amended to allow corporate and individual investors to qualify for investments in larger businesses, which would essentially involve new stock offerings. This is called the Community Enterprise Investment Tax Credit.)

As of April 2009 a total of 12 community enterprises had been approved under the Community Enterprise Development Tax Credit. Nine of the enterprises are located in rural Manitoba and three in Winnipeg. A total of $1.9 million had been invested in them. Capital raised through the tax credit has ranged from $100,000 to $400,000 per enterprise, with an average local investment of about $160,000.[4]

[4] Interview with staff member, Manitoba Department of Agriculture, Food, and Rural Initiatives, June 2009.

(photo) In Winnipeg's inner city, equity tax credits helped capitalize the conversion of Pollock's Hardware from a sole proprietorship into a co-operative (www.pollockshardwareco-op.ca.) Photocredit: John Latham.

The Programs Compared

Nova Scotia's tax credit program has a 10-year record, Manitoba's only five. Yet even when that fact is taken into account, there is a great discrepancy between the utilization of the programs in the two provinces. Why has Nova Scotia, with a population three-quarters the size of Manitoba's, made use of this capital-mobilizing tool so much more intensively? In its first five years, Nova Scotia's program had already given rise to 21 CEDIFS (seven of which had had two offerings and two of which had had four offerings), all for a total of $21 million. That works out to about twice the number of projects and 10 times the capital invest-ment that Manitoba's program has achieved in its first five years.

The two programs have very similar eligibility criteria, including a very flexible definition of CED (one that most CED practitioners would be more likely to refer to as "local economic development"). Both provide for an initial 30% tax credit. The Manitoba program restricts investments in a few industrial sectors, but most of the Nova Scotia investments would have qualified under the Manitoba regulations. The Manitoba program requires investments to be held for only three years, whereas the Nova Scotia credit demands five years. This would seem to provide a significant advantage to the Manitoba program. But it is partially offset by the fact that there are additional, follow-on tax credits in the instance of Nova Scotia. Moreover investments are RRSP-eligible in Nova Scotia. Since most Nova Scotian offerings are timed to take advantage of that eligibility, this difference may indeed be critical.

One other program element might give a significant advantage to Nova Scotia. Its program specifically promotes and facilitates joint investment efforts, the CEDIFs, whereas Manitoba discourages them. Additionally, Nova Scotia extends eligibility to investments "pooled" in a CEDIF for application to more than one enterprise, including unspecified, future projects. Five have been established to date. Manitoba's program does allow for investment funds to be pooled in advance of a designated purpose. Although a CEDIF as such is not encouraged in Manitoba, the tax credit investments are, after all, promoted by groups of local citizens who organize themselves to do this, and thus the CEDIF structure itself would not seem to be material. Yet the very fact that it is a formalized instrument may have a promotional advantage. (Significantly, prior to the introduction of the CEDIF option, few Nova Scotians took advantage of the Equity Tax Credit to invest in an individual local business.) Furthermore, the formalized CEDIF is clearly an instrument to monitor and assist a business in trouble.

It might also be noted that there is a specific government division for CED located in Nova Scotia's Department of Economic and Rural Development, which administers and promotes the CEDIF credits for urban settings as well as rural ones. In the early stages, departmental staff expended much effort to publicize the program and to assist interested groups, as well as to assist its regional offices to do the same. (With the CEDIF approach established, the central department staff no longer has to provide much assistance. The regional offices are active proponents, and citizens' groups help each other.) Moreover, the Department maintains a website that provides all relevant documents, forms, updates, and instructions.

Contrast this with Manitoba, where the tax credit program is not formally promoted within the main urban center, Winnipeg. Nor for that matter has Manitoba promoted the program on a provincial level; promotion is the purview of regional officers. The Manitoba government website offers little more than a brief description of the program, and a government phone number to call for further information.

Apart from differences between these two jurisdictions in terms of program history, design, and administration, the difference in context too may help to explain much of the disparity in uptake. We would suggest that three key factors contribute to that difference.

Factors of context & design seem to have skewed the impact of an investment tax credit in favour of the setting that institutionalizes, promotes, & specifies the CED approach: a process that makes profitable business one integral part of a local movement to build a community that is creative, inclusive, & sustainable.

The first is a difference in the provincial culture of co-operatives and CED. Since both provinces have tended to be overlooked by national and international economic forces over the years, both have had to create a variety of interventions to build local economies. But there has been a higher degree of marginalization in Nova Scotia, and its government has a longer and stronger tradition of promoting co-operative and community development enterprises to redress that. In fact, the co-operative sector has incubated and nurtured much of the province's social enterprise activity. Finally, Nova Scotia has the distinction of having launched the first community development corporation in Canada almost 30 years ago, New Dawn Enterprises. It remains an outstanding example of CED success and was among the initial organizers of a CEDIF. (New Dawn later also took a role when the co-operative structure was first used for a CEDIF.)[5]

At the same time, Manitoba stands out for having formally established a "CED lens" that must be applied to any provincial programs or legislation. The province has a very vibrant CED sector. But targets for equity investment are scarce. Originally, program designers had hoped that the tax credit would prove to be an important instrument for capitalizing social enterprises in Winnipeg, as well as rural areas. But the social enterprise sector in Winnipeg is not as mature as the *community* enterprise sector in Nova Scotia. A recent study[6] of 17 social enterprises in Winnipeg indicated that most were relatively small, half employing fewer than five people and only two employing more than 20. Two-thirds of these enterprises required grant or donation money to start. Two-thirds of them still need subsidies to remain financially viable.

A CED tax credit is designed for circumstances where investors have a reasonable likelihood of some day recovering the funds that they initially invested. Fragile enterprises that require ongoing subsidies to remain financially viable do not provide that likelihood. Thus they are not attractive investment opportunities, even when their appeal is enhanced by the prospect of an investment tax credit. In Winnipeg the demand for non-repayable equity capital (that is, grants) is still considerably higher than the demand for share capital investments.

Secondly, Nova Scotia has an institutional advantage. For some years now, the Nova Scotia Cooperative Council has played a very active role in promoting and facilitating the use of the CED Tax Credit to stimulate co-operatives. It has researched new opportunities for these enterprises and advocated programs and policies to support the co-operative sector. It has provided services to assist co-operative business planning and management and strengthened the networking within the sector. In some cases the Council actually sponsored the creation of co-operative enterprises. It was instrumental in gaining eligibility for the co-op format for CEDIFs and has itself accessed the CED Tax Credit to organize and promote three CEDIFs.

Thirdly, there is a greater imbalance between the urban and rural population in Manitoba than in Nova Scotia. In the prairie province, 65% of the population resides in a single urban centre, Winnipeg. In Nova Scotia, the largest city (Halifax) represents only about 41% of the total population. But the tax credit in both provinces is more highly utilized in small town and rural settings. Since Nova Scotia has more of its population in those settings, the likelihood of its use there would be greater for that province. Urban settings may be less receptive to the equity tax credit programs because their residents lack the more intimate network of personal relationships that characterize rural contexts, as suggested earlier. Where people know each other better, they may find it easier to identify with the business to be supported. They may also feel greater assurance about the due diligence of the promoters and their commitment to monitor the performance of the investments closely.

Together, all these factors of context and design seem to have skewed the impact of an investment tax credit in favour of the setting that institutionalizes, promotes, and specifies the CED approach: a process that makes profitable business one integral part of a local movement to build a community that is creative, inclusive, and sustainable. In short, a tax credit by itself is a powerful tool in the hands of an aware and mobilized community. But a tax credit alone will not solve the local development problems that a community must address.

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[5] For further orientation on Nova Scotia's CED/co-op culture, see S.E. Perry, "What's So Special About Nova Scotia," *Making Waves* 19,4 (Winter 2008): 23-25.

[6] Garry Loewen, Brendan Reimer, and Alex Chernoff, "Creating a Robust Social Enterprise Sector in Winnipeg" (Manitoba Research Alliance, March 2009). 6 January 2010 <http://www.manitobaresearchalliance-tiac.ca/files/SocialEntertrpiseGarryReport_apr_2_09.pdf>.