Small Business Commission
May 19, 2011
Richmond, Virginia

The first meeting of the Small Business Commission of the 2011 interim featured presentations focusing on increasing small businesses' access to capital and legislative developments. The first order of business was the re-election of Senator Roscoe Reynolds and Delegate Glenn Oder as co-chairmen of the Commission.

<u>The Link between Small Business, Jobs, and the Mortgage Crisis</u>

Dr. Samuel D. Bornstein, professor at the Kean University School of Business and a member of the firm of Bornstein & Song CPAs, provided the Commission with the results of research on the link between small business, jobs, and the mortgage crisis. He found that during the housing boom years of 2004-2007, a significant number of small business owners, in their search for capital, were attracted to cash-out refinancing of their built-up home equity using mortgages that required no or minimal documentation or deferred principal payments for the first several years of the loan term. He characterized mortgages that required sharply increased monthly payments after an initial period of minimal or negative amortization as "toxic" loans because the borrowers were not prepared for the increases when the loans were reset or recast.

He reported that 80 percent of the total debt owed by small business-owning households was held in residential home mortgages. Home-equity loans were attractive because they did not require the same level of cumbersome paperwork, including financial statements, income documentation, and an established credit history that was required of business loans. In Dr. Bornstein's view, many of these small business owners are at risk of financial distress, foreclosure, and business failure when their toxic mortgages are due to reset or be recast in 2011-2012. When the monthly mortgage payments are reset or recast, they will double and triple to unaffordable amounts, resulting in payment shock. In his opinion, these resets will usher in a second tsunami wave of foreclosures.

Dr. Bornstein focused on enterprise zone programs, most of which offer sales tax breaks, jobs tax credits, and other incentives but lack any significant incentives to promote small business lending to businesses. Four states (California, Illinois, Indiana, and Rhode Island) allow a net interest deduction (NID) for the lender on loans made to businesses in enterprise zones. He has recommended modifying the NID concept to address the small business owner’s use of the home equity to access capital for the business, and calls it a refined net interest deduction (RNID).

An RNID for lenders in Virginia can be structured either as a subtraction from federal taxable income for lenders or a tax credit for lenders. Under this legislation, a lender is required to pass along the tax savings achieved as a result of the tax-free treatment of the interest income earned from residential mortgage loans, where the mortgagor used all or part of the loan proceeds to invest in the small business located within an enterprise zone. Dr. Bornstein concluded that the lender’s tax savings should immediately flow down to the small business owner to reduce the monthly mortgage payment on the residential mortgage loan and thereby make it more affordable. Under this proposal, the lender serves as a conduit through which tax savings flow from the state to small businesses to lower the monthly mortgage payment. The lender is also required to modify the residential mortgage loan from which the interest income is derived. This loan modification could be accomplished by an interest rate reduction, term extension, principal reduction, or principal forbearance.

Several members expressed skepticism about Dr. Bornstein's solutions. Concerns included the unfairness of protecting those who made "stupid" decisions, intervening in a free market system that allows failures, and singling out a narrow group for a benefit. Some members also questioned whether it would help homeowners with an existing mortgage loan balance that substantially exceeds the home's equity, thereby precluding the refinancing of the mortgage. Co-chairman Oder asked any members who were interested in pursuing Dr. Bornstein's proposal to work with staff on preparing legislation and returning to present the proposal at a future Commission meeting.

<u>Qualified Small Business Initiative</u>

A second approach to increasing the financing available to small businesses was offered by Barry DuVal of the Virginia Chamber of Commerce and Fred Russell of Virginia Capital Partners. Their approach, which they call the Virginia Qualified Small Business Incentive (VQSBI), is based on businesses raising capital through equity investments rather than through incurring loan debt.

Small businesses have historically had trouble borrowing from traditional lending sources. This problem is particularly acute today. Entrepreneurs who might borrow against their houses to provide capital are now unable to do so because of the combination of lower housing prices and reduced bank lending. In order to stimulate small business creation and growth to foster job creation, Mr. DuVal and Mr. Russell contend that it is in the Commonwealth's best interest to encourage and incentivize angel investors in Virginia.

The Commonwealth currently offers a Qualified Equity and Subordinated Debt Investment Tax Credit as an incentive for investors in small businesses in Virginia. Under this program, the credit is paid to investors today and the future benefits from small business jobs creation are generated in the future. However, the types of businesses eligible for the credit are limited and the aggregate amount of the credit is capped.

To address these shortcomings, Mr. Russell proposed that Virginia enact a VQSBI. It would be modeled on the federal qualified small business stock capital gain exclusion. The federal tax provision allows an angel investor to exclude gains realized from the sale of a small business investment from taxable income, provided the investor holds the investment for at least five years. He believes that the fiscal impact of a VQSBI would be minimal because the tax benefits are realized at least five years after the investment is made, and the corresponding jobs created have paid taxes for five cumulative years. Moreover, the losses realized from the investments in small businesses that fail have a limited tax revenue impact because capital losses can only be deducted against ordinary income to the extent of $3,000 per year. Those new firms that succeed will not impact the budget for at least five years and should generate more in tax revenue to the state through new jobs creation, sales tax, property taxes and income taxes from the successful business.

The VQSBI tax incentive would allow angel investors to allocate capital to opportunities that they believe will be successful. The market, which historically has been the most efficient means of allocating capital to its highest and best use, will determine how the capital should be allocated. The VQSBI would eliminate professional investors and any organized pool of capital. The VQSBI tax incentive could be limited to no more than $500,000 of investment per individual per company. In sum, Mr. DuVal and Mr. Russell contend that a VQSBI would be unique in the nation and would attract capital to the Commonwealth.

Co-chairman Oder asked staff to prepare legislation that would implement the VQSBI tax incentive and have it available for discussion at a future meeting of the Commission.

House Bill 2522: Virginia Home Solicitation Sales Act

Co-chairman Oder introduced House Bill 2522 during the 2011 Session of the General Assembly. The bill, which would have removed from the statutorily authorized form of the notice of a buyer's right to cancel a home solicitation sale a provision that allows notice of cancellation to be sent by telegram and amended the notice form to allow notice of cancellation to be sent by facsimile, was passed by in the House Commerce and Labor Committee at the patron's request after concerns were voiced that the measure may have unintended consequences. The chairman of the Committee requested, by letter, that this Commission examine the policy issues raised by the legislation.

The bill's patron requested that the matter by placed on the agenda for the next meeting of the Commission. At that time, both the specific provisions of House Bill 2522 and related issues of the Virginia Home Solicitation Sales Act will be discussed.

Small Business Legislation from the 2011 Session

Staff provided the members of the Commission with an overview of legislation of particular interest to the Commonwealth's small businesses that passed during the 2011 General Assembly Session. These measures included:

- House Bill 1437 (Del. Cole), which allows localities to decide whether to impose the business, professional and occupational license tax either on a business's gross receipts or its Virginia taxable income.

- Budget Bill § 1-7 G, which requests JLARC to study the impact on local revenue streams of restructuring the BPOL tax such that the basis of the tax is changed from gross receipts to net income.

- House Bill 1587 (Del. Iaquinto), which permits any county, city or town to provide exemptions, rebates, or other relief from BPOL taxes to any business locating in such locality for the first time, for the first two years after such location.

- House Bill 1837 (Del. Garrett) and Senate Bill 1264 (Sen. Vogel), which create an income tax credit for licensed farm wineries and vineyards equal to 25 percent of the cost of certain winery equipment and materials.

- House Bill 1942 (Del. Pollard), which creates a sales tax exemption and a litter tax exemption for sales of agricultural produce and eggs at farmers markets and at roadside stands if the seller's annual income from such sales does not exceed $1,000.

- Senate Bill 1408 (Sen. Ruff), which allows localities to exempt from the BPOL tax businesses that lost money.

- Budget Bill Item 98 B 2, which revises the Virginia Small Business Financing Authority's Loan Guaranty Program.

- House Bill 1599 (Del. BaCote) and Senate Bill 1348 (Sen. Norment), which eliminate the requirement that an independent certified public accountant licensed in Virginia attest to the accuracy of certain information in enterprise zone applications if the business' base year employment is 100 or fewer positions and the business is creating 25 or fewer grant eligible positions.

- House Bill 1982 (Del. Kilgore) and Senate Bill 1379 (Sen. Stanley), which reduce the eligibility threshold for awards from the Governor's Development Opportunity Fund.

- House Bill 2324 (Del. Lingamfelter) and Senate Bill 1485 (Sen. Newman), which relate to the establishment of a Small Business Innovation Research Matching Fund Program for Virginia-based technology businesses.

- House Bill 1592 (Del. Iaquinto), which requires all state authorities, regional entities, and other political subdivisions of the Commonwealth, other than localities, to put requests for proposal and invitations to bid on the Department of General Services' website.

- House Bill 1859 (Del. Anderson) and Senate Bill 1049 (Sen. Barker), which require any employer with more than an average of 50 employees for the previous 12 months that enters into a contract in excess of $50,000 with any state agency to register and participate in the federal E-Verify program.

- House Bill 1929 (Del. Marshall, D.W.), which requires that whenever the lowest responsive and responsible bidder on a public contract is a resident of any other state, and that state under its laws allows a resident contractor of that state a price-matching preference, a like preference shall be allowed to responsive and responsible bidders who are residents of Virginia.

- Senate Bill 1107 (Sen. Hanger), which increases the small purchases exemption under the Virginia Public Procurement Act for single or term contracts for goods and services other than professional services from $50,000 to $100,000.

- House Bill 2401 (Del. Wright), which increases, from two to three, the number of full-time farm and horticultural laborers an employer may have in service and remain exempt from requirements of the Workers' Compensation Act.

- House Bill 2006 (Del. LeMunyon) and Senate Bill 1070 (Sen. Edwards), which revise the process for the notice of completion of the small business impact statement and review of existing regulations to minimize the economic impact of regulations on small businesses.

- HB 2206 (Del. Comstock), which repeals the Bulk Sales Act.

Public Comment

Nicole Riley of the Virginia Chapter of the National Federation of Independent Business addressed the Commission during the public comment period to add to the list of important measures addressed in the 2011 Session. She mentioned that the Budget Bill included provisions phasing out the accelerated sales tax collection provision and eliminating regulatory fee increases. She also alerted the Commission to issues relating to the implementation of the federal health care reform legislation and to proposed legislation that would have incentivized insurance companies to fund Small Business Investment Companies.

Future Meetings

The Small Business Commission plans to hold its next meeting in August. Issues to be addressed at that time include the Virginia Home Solicitation Sales Act, the Qualified Small Business Incentive, and an issue related to the requirement that an individual own a majority of the equity in a small business in order for the business to qualify for certification under the SWAM program. In addition, Senator Ruff has requested that the Commission examine the BPOL tax in a future meeting.

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