Passive Business Rule: Overview

I. <u>Overview:</u>

The revisions of the passive business rule are critical to ensure SBICs:

(1) Are able to attract foreign investment into US Small Businesses.

(2) Are able to attract non-profits, endowments, pensions etc. for investment. These are the type of entities most likely to be interested in impact investing and are the most sensitive to these rules.

3) Remain competitive in the small business financing marketplace and can get capital to small businesses that need it;

(4) Can continue to attract limited partner investors that are non-profits (university and private endowments, pensions) and/or foreign investors investing in the United States through these funds; and,

(5) Permit BDCs with SBIC subsidiaries to invest equity in small businesses, ensuring the profitability of their SBICs and taxpayer protection for the leverage they are drawing from SBA, as well as that the small businesses they invest in can access that investment.

II. <u>Why are Passive Businesses Needed?</u>

Passive Businesses/Blocker Corporations Are Necessary to Pay Tax, and Prevent Loss of Special Tax Status. A "blocker corporation" (passive business in SBA terminology) is created so that the tax is paid (blocked) by that corporation entity, before distributions to investors, so the corporation fills out a tax return and the individual investors do not have to fill out a return, and do not lose their special tax status.

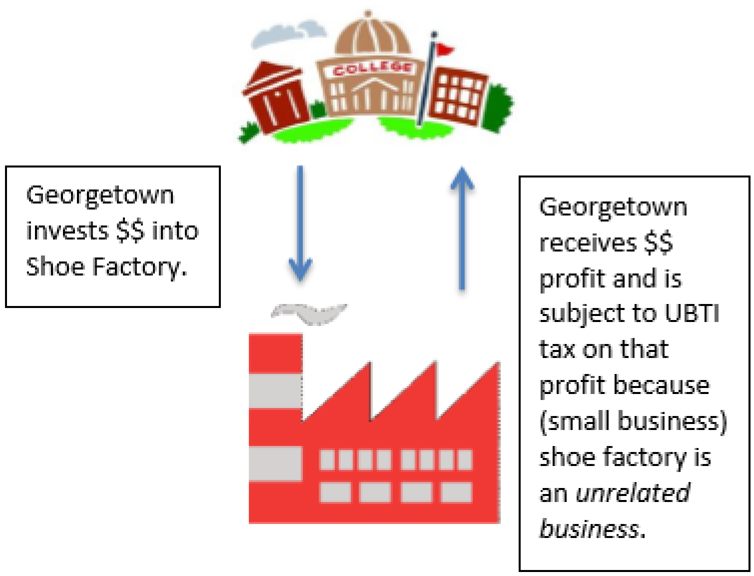
- **Taxes ARE being Paid to the IRS With These Structures:** <u>Taxes are fully paid by the blocker corporation/passive business</u>. These structures ***<u>do not prevent</u>*** taxes from being paid.
- **Blocker Corporations Protect the Tax Status of Some Non-Profit and Foreign Investors, while still fully paying taxes on returns generated by investments:**

III. <u>Explanation of Why Passive Businesses are Needed (In Context):</u>

<u>Non Profit Investors in SBICs:</u> Non-profit investors are tax exempt under U.S. tax law. Filing a tax return for returns paid pre-tax to the tax exempt entity would jeopardize their tax exempt status. Blocker Corporations are formed to pay the tax, with remainder passed along post-tax to the tax exempt investor, preserving tax-exempt status.

Under the federal tax laws, certain tax-exempt investors (such as endowments, pension funds, charitable trusts etc.) are required to engage only in "passive" investment activities in order to retain their “tax exempt” status. These investors often invest in SBICs and private equity funds to grow their endowments. **If they cannot retain this tax-exempt status, they will not invest in a fund, and will choose other assets to invest in.**

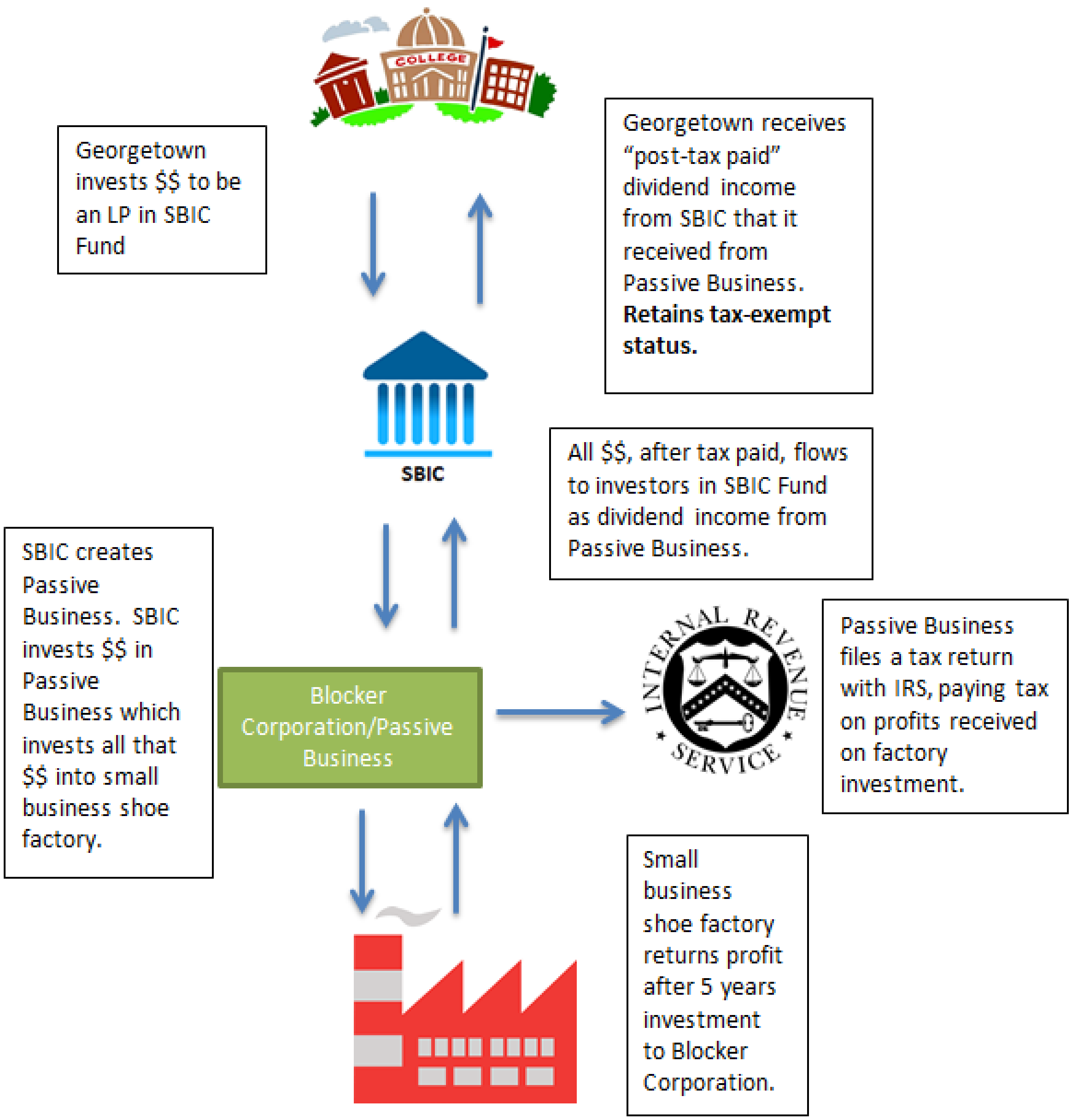
These investors are subject to being taxed under the “unrelated business taxable income” (UBTI) rules, put forward by the IRS. UBTI rules apply to any income derived by the non-profit from any (1) “unrelated trade or business”, (2) regularly carried on, and (3) unrelated to the purpose/goals of the non-profit. For example, if the Georgetown University Endowment invested money directly in the form of equity (stock) into a shoe factory (which is a small business) for five years, and then sold their investment, taking a profit, they would be subject to UBTI on the profit they received. That is because the shoe factory is an “active business” (making shoes), the business of the shoe factory had gone on for five years (regularly carried on), and a shoe factory has nothing to do with Georgetown University’s endowment, which was created to fund the operations of the university for educational purposes. As such, Georgetown University’s endowment would not make that investment because they would be subject to UBTI.



When investing through a “partnership” structure (General Partner/Limited Partner) (which all SBICs are currently structured as), tax liability for UBTI flows through the partnership to the investors in the partnership.

Example 1: If Georgetown University’s endowment invests into SBIC Fund as a limited partner (LP), which then invests in the small business shoe factory, the tax liability from that investment flows through SBIC to the University, putting it at risk for UBTI, and losing its tax exempt status. However, if SBIC fund creates a “C” corporation (which pays taxes), the C Corporation or “blocker corporation”/passive business, will pay the tax to the IRS, and the leftover profit will be moved up to through dividend income to Georgetown, without harming its tax exempt status.

Unrelated Business Tax Income (UBTI) Blocker Diagram



Foreign Investors in SBICs: Certain foreign investors (such as sovereign wealth funds, foreign banks/funds etc.) want to invest in the United States, but do not want to, or may not be able to file their own tax return in the United States for income they receive from investments in the United States. Under the IRS rules, when a foreign person engages in trade or business in the United States, all income from sources in connection with the trade or business are considered to be effectively connected income ("ECI"). The IRS rules have a number of categories of income which are considered to be connected with a trade or business and subject to ECI taxation.[1] The most important context here is if the foreign entity owns or operates a business in the United States selling services, products or merchandise, profits received are subject to ECI. This is true even if they are investing through a partnership, like an SBIC – just as with UBTI, without a blocker, this tax liability flows up from the small business through the fund, to the investors, and would require a foreign entity investor to file a tax return.

Why Allow Foreign Investors To Structure This Way?:

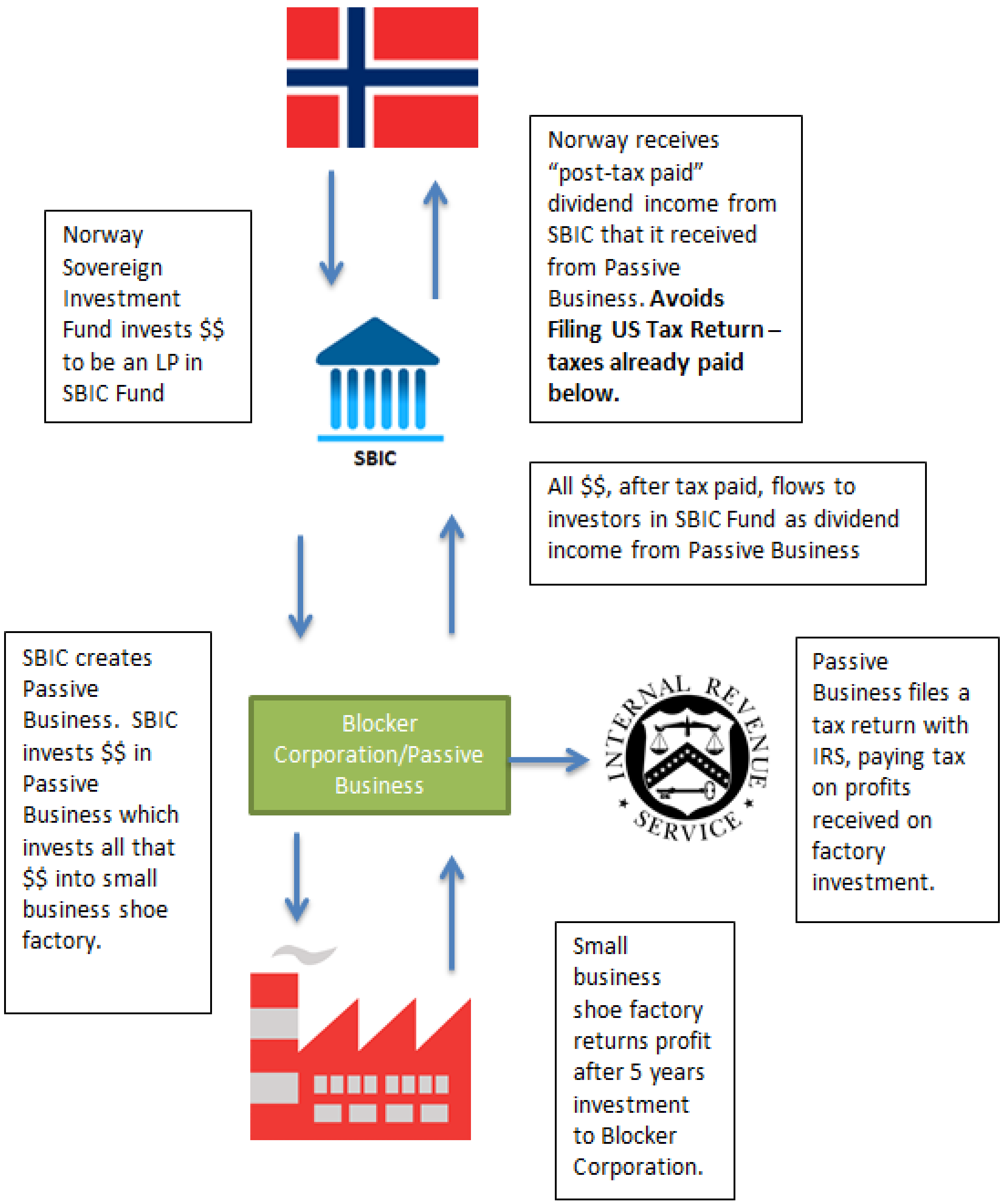
- **Encourage Foreign Investment in US Small Businesses:** If we want to encourage foreign investors to invest in SBICs, which under their regulations are required to invest domestically, we need to provide this protection to foreign investors.
- **Avoid Foreign Investors Choosing Other Assets:** If foreign investors do not have this protection when investing in SBICs, they will choose other assets to invest in, ultimately diminishing the available capital via SBICs. This will reduce the amount of small business capital available and likely make it more expensive.

Again, the **important thing is that <u>these investors are paying the taxes on the profits to the IRS</u>**; they are paying at the corporate level and rate, but would not have to file an additional US tax return.

Example 2: If Norway Sovereign Wealth Fund believes there are good returns to be had by investing in U.S. small businesses, it might invest in the same small business shoe factory in California, for five years, and take a profit after selling it. Because the Norway Sovereign Wealth Fund is a Norwegian government entity, it may not be permitted to pay taxes to other countries. Regardless, under this scenario, the Norway Sovereign Wealth Fund would need to file a U.S. tax return to pay the "effectively connected income" that it received because it "owned or operated a business in the United States selling products or merchandise." As such, the foreign entity would not make that direct investment. Similarly to with UBTI, under ECI, if the Norway Sovereign Wealth Fund invested in an SBIC, without a passive business paying the tax for them, the ECI tax would flow through to the Fund, and Norway Sovereign Wealth Fund would have to file a U.S. tax return. However, if the SBIC fund creates a "C" corporation (which pays tax itself), the C Corporation or "blocker corporation"/passive business, will pay the tax to the IRS, and the leftover profit, as dividend income, will be paid out to Norway Sovereign Wealth Fund.

[1] https://www.irs.gov/individuals/international-taxpayers/effectively-connected-income-eci

Effectively Connected Income (ECI) Blocker Diagram



BDC/RIC Status Protector for BDC SBIC Subsidiaries: A significant number of Business Development Companies ("BDCs") have SBIC subsidiaries. BDCs were created in 1980 and are governed under the requirements of the Investment Company Act of 1940 ("40 Act"). The legislative history of BDCs indicates that when they were created by Congress in 1980, the intention was for BDCs to work together with SBICs to channel capital to small businesses. BDCs are eligible to qualify as a regulated investment company ("RIC") under the Internal

Revenue Code. If a BDC qualifies as a RIC, it may not be subject to corporate-level taxes. Almost all BDCs qualify as RICs.

In order to qualify as a RIC, a BDC must meet three primary requirements under the Internal Revenue Code.[2] First, at least 90% of the BDC's annual gross income must be derived from dividends, interest, gains from the sale or exchange of securities and other "qualifying" or "good" income associated with the business of investing in securities.[3] "Non-qualifying income" or "bad" income is income received from other sources by the BDC. Second, at the end of each tax quarter, at least 50% of a BDC's assets must be invested in cash items, securities of other RICs, government securities or other securities (provided its investment in any one security does not exceed 5% of a BDCs total assets.[4] Third, a BDC must distribute at least 90% of its annual investment company taxable income, which is defined as ordinary income plus short-term capital gains.[5] The first item is implicated in terms of investing through BDC owned SBICs.

The IRS requires that RICs "look through" to all the entities that are owned or invested in by the BDC for purposes of qualifying as a RIC. This includes partnerships in which a BDC may be invested, such as an SBIC, and the holdings in small businesses of that SBIC. **If these partnerships, including an SBIC, own equity investments in operating companies, these investments would be considered as non-qualifying assets, and the income generated by them would be "bad income" therefore implicating RIC status**. As a result, a BDC must be very careful when making investments in their SBIC that involve owning equity, or the right to acquire equity, such as warrants. Many BDCs will make debt investments, in which warrants are offered, and will be unable to make those investments in the SBIC because of the "bad income" that would be generated, and flow up to the BDC.

Why Allow BDCs to Do This?:

- **Finance Small Businesses:** Providing flexibility for a BDC to create a passive business or blocker corporation will permit BDCs to make investments in the equity/stock of small businesses that their underlying SBICs invest in. These investments contribute significant benefit to businesses that might otherwise not be able to receive this capital elsewhere, but the BDC's SBIC.

- **Protect Taxpayer Dollars:** Allowing a blocker and these investments ensure that the SBIC under the BDC generates sufficient revenue to make sure the SBA debentures are paid back, and taxpayers are protected.

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[2] Robert Meiner, *Tax Issues for Business Development Companies*, Ernst & Young (September 2012), *available at:* *http://www.ey.com/Publication/vwLUAssets/Tax_issues_for_business_development_companies/$FILE/EY-Tax-issues-for-busines-development-companies.pdf*

[3] *Id.* at 1-2.

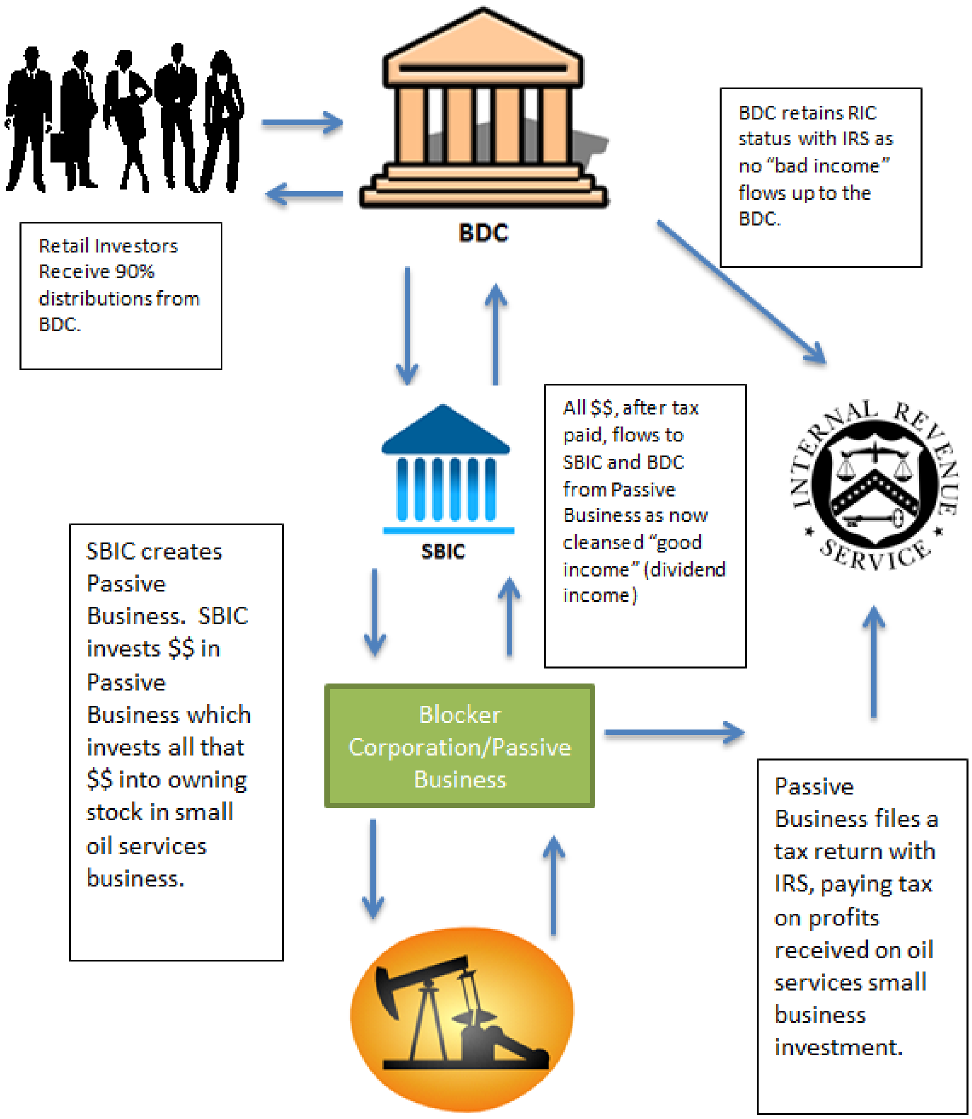
[4] *Id.* at 2-3.

[5] *Id.* at 3.

- **Protect Retail BDC Shareholders:** Allowing these investments contributes to the benefits for shareholders, many of which are individual retail shareholders of the BDC, will benefit from RIC status and receive dividend income from BDCs.

Example 3: A BDC which has retail shareholders, and is publicly traded on the New York Stock Exchange, has qualified as a RIC with the IRS. It and its public shareholders want the BDC to remain a RIC. The BDC forms an SBIC, a wholly owned subsidiary, which receives a license from the SBA to operate as an SBIC. The SBIC invests equity and debt into small businesses. If the SBIC makes a loan to Oil Service Small Business, and takes a stock/equity ownership stake in that small business, operating income is generated through owning that stock. The operating income then will flow up to the BDC as "bad income" and harm its retail shareholders because the BDC will be at risk of losing its RIC status with the IRS. If the SBIC is permitted to create a passive business/ blocker corporation, the passive business will pay tax to the IRS and the income can then flow up to the BDC as "good income" as it is no longer "operating income" but is now "dividend income" from the passive business to the BDC. RIC status is not impacted, because the bad income is eliminated by having it pass through the blocker.

BDC Blocker Diagram



<u>Eliminate Ownership Requirements for 2 levels of Passive Businesses:</u> Many SBICs need to be permitted to have more than one level of passive business in order to participate in certain investment opportunities. As primarily providers of debt to an investment deal, the SBIC usually does not dictate the structure of the investment, like the equity investor does. If an SBIC cannot fit into the deal, then the equity investor may seek another provider of capital. This may result in less profitability for an SBIC (as the best deals they might not be able to compete on), and therefore more taxpayer risk for the fund. It might also mean that the small business may have another, more expensive debt provider brought into the deal that might fit into the structure, and miss out on the attractive, cheaper financing of an SBIC. For these reasons, it's critical for an SBIC to be able to be able to invest into deals with multiple levels of passive businesses, and not

necessarily have to have 50 percent ownership. The current rules permit two levels of passive business, but require a 50 percent ownership of the voting securities of the passive business – many times the SBIC is not in the control position and cannot make this work.

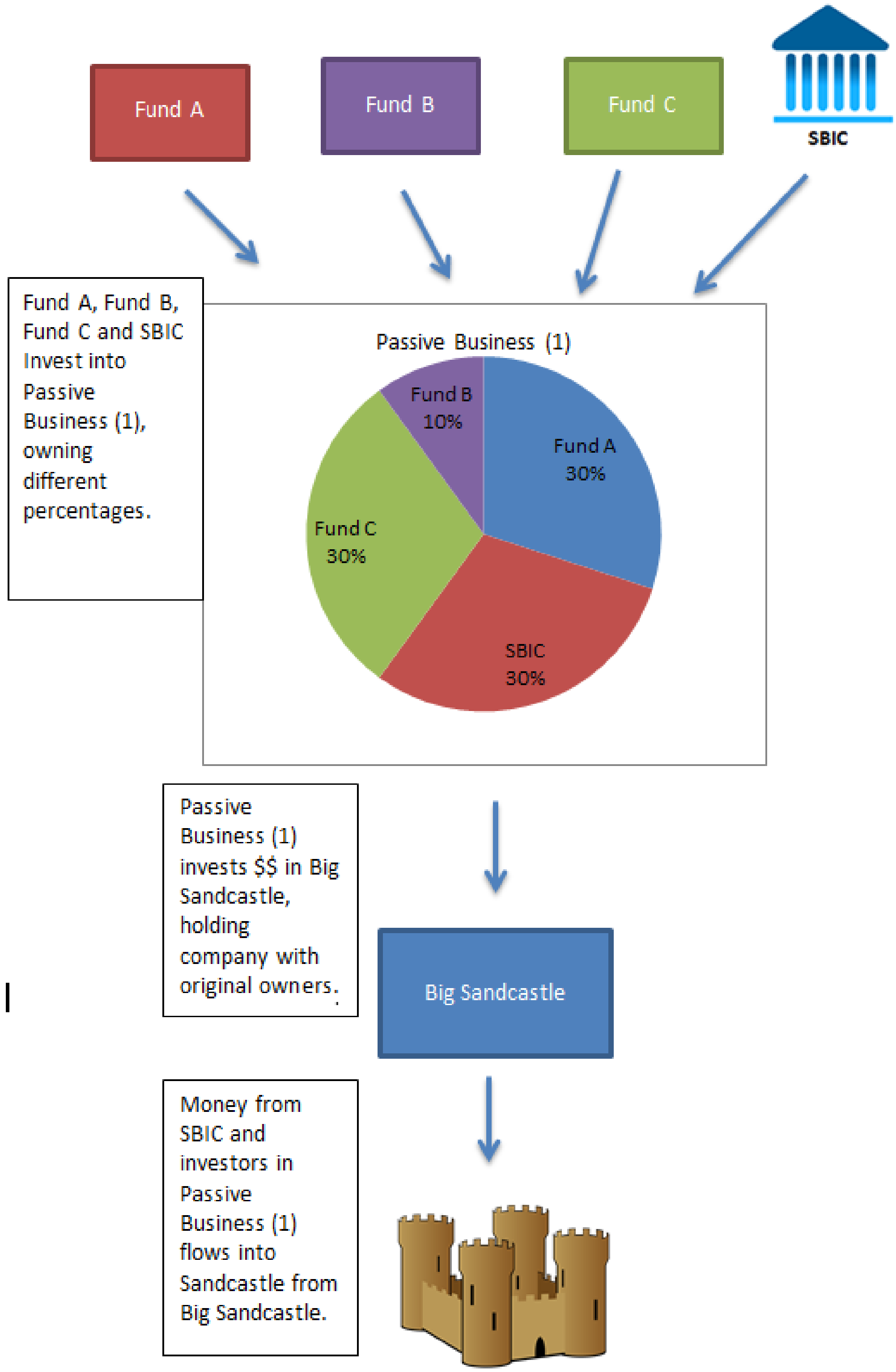
Why Permit SBICs to Have Multiple Passive Businesses & Less Than 50% Ownership?:

- **SBICs will be excluded from Financing Small Business Deals:** SBIC funds will not be able to participate in certain deals where they are not in control of the financing structure.

- **Small Businesses Will Have a Higher Cost of Financing:** If SBICs cannot participate in the deals, another junior capital provider may be sought, which could raise the cost of capital for the small business being financed.

- **Taxpayers are protected by Successful SBIC Investing:** If SBICs are blocked from being normal market participants they will get worse opportunities therefore SBA Debentures will be at greater risk..

Example 4: An SBIC was invited to invest with a private equity sponsor, Fund A, Fund B, and Fund C, into Sandcastle, Inc., an operating company that had an existing holding company called Big Sandcastle with the original owners of Sandcastle invested in it. Also investing through Passive Business (1) were Fund B and C where the SBIC would not have a 50% voting ownership of Passive Business (1). Under current regulations, the SBIC would not be able to invest in this deal. We would like this type of structure to be permissible given market realities.


Fund A
Fund B
Fund C
SBIC
Fund A, Fund B, Fund C and SBIC Invest into Passive Business (1), owning different percentages.
Passive Business (1)
Fund B 10%
Fund A 30%
Fund C 30%
SBIC 30%
Passive Business (1) invests $$ in Big Sandcastle, holding company with original owners.
Big Sandcastle
Money from SBIC and investors in Passive Business (1) flows into Sandcastle from Big Sandcastle.