

Investment Funds and SBIC Practice

Small Business Administration Relaxes Restrictions on SBICs Investing in Passive Businesses

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On December 28, 2016, the Small Business Administration (the SBA) finalized rules allowing a Small Business Investment Company (an SBIC) increased flexibility to invest through passive entities (i.e., holding companies without operating businesses). The full text of the final rules (the Final Rules) is available [here](#).

Background

For a variety of business, legal, tax and other similar considerations, many private investments are made through one or more passive holding company entities. The Small Business Investment Act of 1958 (as amended, the SBIC Act) prohibits an SBIC's ability to invest through passive entities, subject to a few limited exceptions. Previously, an SBIC could only invest in a passive entity if "substantially all" of the investment was passed to the ultimate small business *and* (1) the investment was made through a wholly owned C-corporation (a Blocker) to prevent Unrelated Business Taxable Income (UBTI) from being passed to the SBIC's tax-exempt limited partners, or (2) there were no more than two levels of passive entities and the top-level entity indirectly owned at least 50% of the small business being financed. SBICs therefore invested in passive entities in two situations: (1) to shield the SBIC's tax-exempt limited partners from UBTI when the SBIC was investing in a portfolio company that was structured as a limited liability company or other type of flow-through entity, and (2) when the SBIC wanted to invest in a holding company that in turn owned a small business. The Final Rules expand the permitted use of Blockers, clarify the requirements for investments made through multiple passive entities, and add additional reporting and regulatory requirements when utilizing passive entities. The Final Rules also codify the increased amount of SBA leverage available to SBICs under common control.

The Blocker Exception

Until now, an SBIC could only use a Blocker to prevent UBTI from being passed to the SBIC's tax-exempt limited partners, and even then, only with the SBA's prior approval. An SBIC was not permitted to use a Blocker to prevent effectively connected income (ECI) from being passed to its foreign limited partners. The Final Rules no longer require SBA approval to form Blockers and also permit an SBIC to form a Blocker to avoid passing ECI to the SBIC's limited partners. In lieu of obtaining the SBA's prior approval, an SBIC must maintain a certification in its files that the Blocker was formed for one of these permitted purposes.

Additionally, the Final Rules now permit SBICs to form Blockers that are limited liability companies taxed as corporations. Previously, the SBA only permitted SBICs to use C-corporation Blockers. Limited liability company Blockers will provide SBICs with greater flexibility when structuring investments without imposing certain corporate formalities required by C-corporations.

The Holding Company Exception

Under prior regulations, an SBIC could only invest through a passive entity if there were no more than two levels of holding companies and the first-level holding company owned a majority of the ultimate financing recipient. For example, an SBIC could structure an investment by investing through Holdco A, with the proceeds going first through its subsidiary Holdco B, and then to Small Business 1, but only if Holdco A owned at least 50% of Small Business 1. The language of the SBIC Act, however, only permitted SBICs to “finance” a passive entity according to the above structure. The SBA clarified its existing interpretation to expressly permit an SBIC to both “form” and/or “finance” such a passive entity. In addition, the Final Rules clarify that the funds can be passed through to an operating company or used to *acquire* an operating company.

The SBA rejected an industry proposal that would allow an SBIC to invest a Blocker into a double holding company structure. Therefore, if an SBIC uses a Blocker, it may structure an investment only through one additional holding company.

Additional Changes Affecting Passive Entity Structures

In addition to the above changes, the Final Rules implement the following:

- **“Substantially All”**: As noted earlier, when structuring an investment through one or more passive entities, the underlying small business must receive “substantially all” of the SBIC’s investment. The SBA clarified the definition of “substantially all” to mean 99% of the investment proceeds, less permitted fees and expenses.
- **Transaction Fees**: Fees charged by an SBIC or its associate when investing through one or more passive entities may not exceed those permitted if the SBIC made the investment directly. If an associate received any such fees, they must be paid in cash to the SBIC within 30 days. SBICs using a holding company structure do not have the ability to offset fees against the management compensation as they would be permitted to do with such fees if the small business were financed directly.
- **“Portfolio Concern”**: The definition of “Portfolio Concern” was revised to now include passive entities utilized in the above investment structures. As a result, such passive entities are subject to the same recordkeeping and reporting requirements required by the SBA from the small business in which the investment is ultimately made.
- **Form 1031**: The Final Rules made changes to Form 1031—the form that must be submitted to the SBA within 30 days after closing an investment. The changes require the SBIC to identify any holding companies used and explain the flow of funds and securities received.

The BDC Exception

Prior to implementation of the Final Rules, Business Development Companies (BDCs) that wholly owned an SBIC subsidiary faced potential adverse tax consequences due to income allocations indirectly received by the SBIC subsidiary. A BDC can elect to be treated as a Regulated Investment Company (RIC), which provides certain tax benefits, only if the BDC satisfies certain income and asset diversification tests. However, BDCs ran the risk of failing those tests and losing their RIC status due to income allocations indirectly received from a wholly owned SBIC. The Final Rules allow a BDC to avoid those adverse tax consequences by extending the Blocker exception described above to BDCs that have a wholly owned SBIC. As a result, the Final Rules permit an SBIC that is wholly-owned by a BDC that qualifies as a RIC to form a Blocker. Doing so will help the BDC avoid compromising its RIC status.

Increased Leverage for SBICs Under Common Control

Lastly, the Final Rules codified the maximum amount of outstanding SBA leverage permitted to be held by SBICs under common control, increasing it from \$225 million to \$350 million in accordance with the Consolidated Appropriations Act, 2016, which was passed in December.

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