

Straight loans must have a maturity of at least five years. While they may be subordinated in some instances, typically, they are secured long term installment notes paying relatively high interest rates. They provide no equity-type capital for the small business concern.

Direct purchases of stock in small companies are generally more advantageous to the small concerns. Stock purchases are nonamortizable and non-interest bearing. These features are important to many newly organized small business concerns that cannot make principal and interest payments, as well as to established concerns which need sizeable funds for new product development, expansion and for other large scale improvements. Large concerns can generally acquire funds through stock issues. Small concerns, however, are characteristically unable to obtain funds through the public securities market, typically because they are either too small or unseasoned. Equity investments by SBICs also serve to improve the balance sheet position of small concerns, enabling such concerns to obtain additional credit and debt funds through customary lending channels.

Debt transactions with equity features provide for repayment with interest by the small business concern; but, more important, carry rights to convert debt into equity or to purchase capital stock at a pre-determined price at the option of the SBIC. Such financing can significantly aid the small business concern. The interest rate on debt with equity features is often less than on straight notes; the rate of amortization is likely to be less demanding; and additional equity funds may be provided to the small firm through the exercise of a stock purchase option.

TAX PROPOSALS

Section 1. Title of bill

This section provides that, when the bill is enacted, it may be cited as the "Small Business Investment Company Tax Amendments of 1967."

Section 2. Bad debt and reserve for loss treatment

The Internal Revenue Code allows a loss deduction for debts which become wholly or partially worthless during any taxable year; or, in lieu thereof, the taxpayer may elect to set up a bad debt reserve. The Internal Revenue Service has allowed SBICs to establish bad debt reserves based upon 10 percent of their outstanding loans. The 10 percent allowance is to apply for a period of 10 years (dating back to 1959), after which an SBIC's own loss experience will be used to determine the reasonableness of further additions to its reserves. The treatment does not extend to debt instruments issued with interest coupons or in registered form.

The bill would allow SBICs an ordinary loss deduction with respect to debts issued with interest coupons or in registered form which become wholly or partially worthless; or, in lieu thereof, the SBIC would be permitted to make appropriate additions to reserves for losses. The amendment would provide an added incentive to SBICs to enter into all forms of debt financing, including investments providing for longer terms, subordination or other equity type features.

Inasmuch as the SBIC program will be undergoing substantial changes in the event of passage of the remainder of its legislative program, SBA has requested the Internal Revenue Service to (1) extend the ten year period for ten percent reserve allowances; and (2) broaden the base for reserve treatment to include those forms of debt instruments which would qualify for loss reserve treatment under the new legislation.

Section 3. Personal holding company tax exemption

Under existing law, the privately owned SBIC may well fall within the Code definition of a "personal holding company" and be required to pay the penalty tax imposed on such companies. The 86th Congress added what is now subsection (c) (8) to Section 542 of the Code to exempt, with certain restrictions, SBICs from the personal holding company tax. These restrictions were believed to be necessary to prevent unwarranted exemption from the personal holding company tax in cases where the SBIC was being utilized as an "incorporated pocketbook" to finance the business ventures of its shareholders and not to serve the purposes of the small business investment program.

As written, subsection (c) (8) denies the exemption to an SBIC if the shareholder of an SBIC also owns a 5 percent or more interest in its portfolio company, no matter how insignificant his interest in the SBIC may be. Additionally, the 5 percent interest in the portfolio company may be "directly or indirectly" owned.