

While there appears to be some uncertainty, this provision could be interpreted to mean that a shareholder of an SBIC owns his prorata share of the SBIC's interest in a portfolio company. As a practical matter, the interpretation would destroy the exemption for those closely held SBIC's that make equity financings. Consequently, the present restrictions have an inhibiting effect upon equity financings by closely held companies and clarification of this problem is desirable.

SBA has promulgated regulations designed to prevent SBIC control of small business concerns and conflicts of interest between SBICs, its shareholders and small business concerns. The bill is designed to conform the treatment of SBICs for tax and non-tax purposes, as well as to avoid the undesirable inhibition which existing law may impose on the activity of closely held SBICs. Under the bill, the Department of the Treasury and SBA will promulgate mutually agreed upon regulations. It is expected that these regulations will closely follow SBA's present regulatory policy on self-dealing and ownership limitations, and any SBIC complying with such regulations will be exempt from the personal holding company provisions.

Section 4. Regulated investment companies

Publicly owned SBICs are required to register under the Investment Company Act of 1940. As with other companies so registered, the SBICs can qualify for the special income "pass-through" provisions of the Code, generally permitting taxation of SBIC earnings at the shareholder's level only, if they meet the requirements of Subchapter M. Because of the diversification requirements of that Subchapter, it is estimated that only 4 of the 40 otherwise eligible SBICs have been able to qualify for "pass-through" provisions.

At present, to qualify for Subchapter M treatment, an SBIC must show at the end of each quarter of its taxable year that it has at least 50 percent of its assets in (1) cash or Government securities, or (2) in other securities representing (a) not more than 5 percent of the assets of the investment company, nor (b) more than 10 percent of the outstanding voting stock of the portfolio company. The present law also limits to 25 percent of its total assets the amount that any single SBIC can invest in securities of two or more small business concerns which the taxpayer controls and which are in the same or similar trade or business.

The diversification tests were aimed at mutual funds, to insure that such companies do not unduly concentrate their assets in any one company or controlled group of companies, nor become operating companies through the use of subsidiaries. On the other hand, SBIC's must be encouraged to invest in new and frequently untried or high-risk situations.

The diversification tests create difficulties for SBICs for the following reasons: The SBIC must be able to invest in stock of small business concerns, a form of investment which incurs risk under present law since it raises the possibility of disqualification from pass-through privileges. The SBIC must be able to own a sufficient portion of such stock of a particular concern to exercise some degree of influence over the management of the concern. The SBIC must be able to invest a sufficient portion of its own assets into a small concern to warrant the pre-investment investigation necessary, particularly since the SBIC typically has a much smaller pool of resources than does a mutual fund. And the SBIC must be free to develop a degree of specialization in a particular industry if it desires to do so.

Under the bill, the test would be applied only at the end of the taxable year; the 10 percent test would, in the case of SBICs, be increased to 50 percent; and the 5 percent of total assets test would be changed to 20% of the total of paid-in capital and paid-in surplus of the SBIC. The latter change conforms to SBA rules on concentration of assets in any one company; it will also prevent resort to artificial borrowing for the sole purpose of enabling the company to meet the test by increasing assets. In order that SBICs may continue to build up a degree of specialization in the same or similar industries, the bill provides that the SBIC will not be deemed to have control over the small business concern unless its ownership consists of more than 50 percent of the total combined voting power of all classes of stock entitled to vote.

The Small Business Administration has promulgated rules generally governing the activities of SBICs in these areas. The bill would thus seek to conform the tax treatment of SBICs with the non-tax treatment wherever appropriate. In keeping with the general purpose of the Small Business Investment Act to encourage SBICs to maintain sources of funds ready for investment in new ventures, availability of the liberalized tests would be curtailed to the extent that the SBIC has continuously held any security of a particular portfolio concern for a period of ten or more years.