

Recognizing the unique nature of SBICs and their investments by relaxing the diversification test applicable to them under Subchapter M would have the effect of encouraging the flow of private capital into the program. The present inability to pass profits directly to stockholders dampens investor interest in the SBIC program and severely hampers SBA's efforts to encourage equity financing by SBIC's.

Section 5. Ordinary losses to SBIC shareholders

Congress enacted in 1958 as part of the SBIC legislation, Section 1242 of the Code which provides that any loss on SBIC stock shall be treated by a shareholder as an ordinary loss rather than a capital loss. As part of the overall SBIC tax revision, the Treasury Department desires that monetary limits be placed on this provision. It will thus generally conform with Section 1244 of the Code, which provides for ordinary deductions by individuals for losses on direct investments in small business stock as defined in that Section.

The Treasury Department and SBA have agreed upon the following proposals:

1. The amount which can be treated as an ordinary loss in any taxable year would be limited to \$25,000 per taxpayer, or \$50,000 in the case of a joint return.
2. Any amount in excess of such limitations may be carried forward as a capital loss to an unlimited number of successive years; and, to the extent not so utilized in each such year, may (within monetary limits as in the year of loss) be treated as an ordinary loss for any taxable year.
3. The limitations will not, however, apply to losses incurred on SBIC stock which was acquired by the taxpayer prior to the date of the introduction of this legislation.

Section 6. Gains and losses on SBIC investments

A major incentive to stimulate private investments in SBICs was the enactment in 1958 of Code section 1243. This section permits SBICs to treat its losses on convertible debentures of portfolio concerns and the stock into which such debentures are converted (the only equity investment permitted SBICs at that time) as ordinary losses. In 1960, Congress amended section 304 of the SBI Act to permit SBICs to make all types of equity investments to small business companies. Section 1243 was never amended to cover the broader range of equity investments.

Section 6 of the bill would extend ordinary loss treatment to losses incurred by SBICs on all types of investments in small business concerns. Debts owed by small business concerns to small business investment companies would be treated as an inventory asset. Thus, losses on any sale or exchange of such assets would be deductible from ordinary income without limitation. Gains on debt would be treated as ordinary income, but this would not represent any substantial change from present law which generally treats such gains as discounted interest.

To the extent that a small business investment company incurs a net loss from sales or exchanges of equity securities, it would be entitled to deduct the amount of such a loss from its ordinary income subject to limitations which are in accord with Treasury Department policies. The amount for the deduction in any taxable year would be limited to \$100,000, and the amount of any deductible loss in excess of this limitation would be carried to a subsequent year and treated as if it had been incurred on an equity security in that year. The term "equity securities" would be defined to mean stock of any class or type; any option or conversion or exchange privilege issued and/or acquired in connection with the purchase of any stock, convertible debenture or debt instrument; or any combination of the foregoing.

To protect the loss position of SBICs which have conversion privileges (or stock acquired on the exercise of such a conversion privilege) in connection with debentures acquired before the introduction of this proposal, a special rule would permit deduction of the full amount of a loss on such stock acquired by exercising the conversion privilege of such a debenture in the year in which the loss is incurred if the loss is incurred on or before March 31, 1972.

By limiting tax advantages to other forms of SBIC financing, Section 1243 presently inhibits SBICs from making direct purchases of stock in small companies. The amendment will remove this disparity and stimulate increased stock investments.

Section 7. Effective dates

The bill provides that the amendments of Section 5 (ordinary losses of SBIC shareholders) shall apply to taxable years ending after the date of enactment; the amendments of section 3 (personal holding company tax exemption) shall