Impact Of The Revised 'Passive Business Rule' On SBICs

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Charlotte Financial Services Members John Gilson, John Evans and Ryan Smith authored a piece that was published by *Law360* on December 5. Their article, "Impact Of The Revised 'Passive Business Rule' On SBICs" addresses the Small Business Administration's recent revisions to the regulations that govern small business investment company (SBIC) investments in "passive businesses" (the "Passive Business Rule"). The article can be seen in its entirety below.

IMPACT OF THE REVISED 'PASSIVE BUSINESS RULE' ON SBICS

On Oct. 21, 2014, the U.S. Small Business Administration announced its revisions to the regulations governing small business investment company (SBIC) investments in "passive businesses" (the "Passive Business Rule"). After years of debate among SBICs, professionals and lawmakers regarding the practical impact of the Passive Business Rule, the revised regulations address a number of the issues discussed over the years, while leaving certain others open for future debate.

So, what are the revisions and what impact do they have on SBICs?

For starters, under specific circumstances, SBICs are now permitted to structure an investment utilizing two levels of passive small businesses (e.g., two holding companies). Prior to the revised regulations, SBICs were generally permitted to structure an investment utilizing only one passive small business (e.g. a single holding company).

It should be noted here that 13 CFR 107.720(b) continues to define a business as "passive" if: (1) it is not engaged in a regular and continuous business operation; (2) its employees do not carry on the majority of day-to-day operations, and the company does not exercise day-to-day control and supervision over contract workers; or (3) the business passes through substantially all financing proceeds to another entity.

Also, as further discussed below, the revised regulations indirectly expand the permitted use of blocker corporations by SBICs (in a limited manner) in cases where the blocker corporation indirectly owns at least 50 percent of the outstanding voting interests of an operating company.

Prior to these revisions, there were two exceptions to the general prohibition on SBICs investing in "passive businesses." These exceptions allowed SBICs to directly finance a "passive business," but only if the end recipient was an active business.

The first exception, contained in §107.720(b)(2), provided that SBICs could make investments in a "passive business" that in turn passed the investment proceeds to one or more "subsidiary companies," each of which must be a nonpassive small business. Prior to the revised regulations, a "subsidiary company" was defined only as a company in which at least 50 percent of the outstanding voting securities were directly owned by the financed passive business. The revisions to §107.720(b)(2) expand the definition of "subsidiary company" to allow financing proceeds to pass through a second passive business before reaching a nonpassive subsidiary.

As revised, "subsidiary company" means a company in which the passive business being financed either (1) directly owns at least 50 percent of the outstanding voting securities; or (2) indirectly owns at least 50 percent of the outstanding voting securities (by directly owning the outstanding voting securities of another passive small business that is the direct owner of the outstanding voting securities of the subsidiary company).

To illustrate, if an SBIC is directly financing a passive holding company ("HoldCo 1"), the revised regulations permit HoldCo 1 to pass the proceeds of that financing through another passive holding company ("HoldCo 2") to a nonpassive operating subsidiary ("OpCo"), so long as HoldCo 1, by virtue of its ownership of HoldCo 2, directly or indirectly owns at least 50 percent of the outstanding voting securities of OpCo.

It should be noted here that the SBA confirmed that "outstanding voting securities" is intended to refer to both the "securities" of a corporation and the "interests" of a limited liability company or limited partnership.

The second exception, identified in §107.720(b)(3), governs the formation and use of blocker corporations by SBICs to shield their investors from unrelated business taxable income. The revised regulations do not directly expand the use of a blocker corporation. Notwithstanding the foregoing, the exception contained in §107.720 (b)(3) is indirectly impacted (albeit in very limited circumstances) by the revisions to §107.720(b)(2).

As revised, §107.720(b)(2) does not specify any purpose for which a passive entity may or may not be utilized. Accordingly, as stated by the SBA, so long as the financing proceeds are passed through only to one or more nonpassive "subsidiary companies" as permitted by §107.720(b)(2), the revised regulations would also allow an SBIC to create a blocker corporation as one of the two permitted levels of passive businesses under §107.720(b)(2): (1) to protect an SBIC's foreign investors from the taxation imposed on income that is considered to be "effectively connected" (ECI) to a U.S. trade or business; and (2) in the case of an SBIC that either is a BDC licensed under the Investment Company Act of 1940 or is owned by a parent BDC, to avoid jeopardizing the BDC's qualification under the Regulated Investment Company regulations.

The impact here is very limited, however, because using a blocker corporation as one of the two permitted levels of passive businesses under revised §107.720(b)(2) would require such blocker corporation to indirectly own at least 50 percent of the outstanding voting interests of the nonpassive subsidiary (see illustration above), which would be atypical for an equity investment made in connection with a loan.

The SBA received comments calling for additional changes to the Passive Business Rule to further loosen the restrictions on investments in passive businesses. The following are notable changes that were suggested but not ultimately adopted:

(1) the elimination of the requirement for SBA prior approval to form a blocker corporation under §107.720(b)(3);

(2) the formation of a blocker corporation to enable its foreign investors to avoid ECI (though see discussion in immediately preceding paragraph); and

(3) the structuring of financings to allow an SBIC to structure financings with an unlimited number of passive entities before the proceeds reach an eligible, nonpassive small business.

What's the biggest takeaway though from all of this? The revised regulations do ease the restrictions on SBICs by allowing two levels of "passive businesses" (e.g. two holding companies), however, the revised regulations will have a very limited impact on the use of blocker corporations. Practitioners and professionals should follow the evolution of 13 CFR 107.720(b) and continue to consult with the SBA when investment structures involve passive entities.

These revised regulations are effective as of Nov. 20, 2014.