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## Passive Business Rule

### Delayed, Withdrawn and Amended –What it Means for You

#### HISTORY

**Jennifer Audeh**

617.832.3016

[jaudeh@foleyhoag.com](mailto:jaudeh@foleyhoag.com)

**Robert Sawyer**

617.832.3071

[rsawyer@foleyhoag.com](mailto:rsawyer@foleyhoag.com)

**Michael Wyatt**

202.261.7320

[mwyatt@foleyhoag.com](mailto:mwyatt@foleyhoag.com)

**Bruce Kinn**

617.832.1137

[bkinn@foleyhoag.com](mailto:bkinn@foleyhoag.com)

Small Business Investment Companies (“SBICs”) are generally prohibited from investing in passive (i.e., non-operating) small businesses under the Small Business Investment Act of 1958 (the “Act”) and its implementing Regulations. Prior to the amended passive business rule now in effect (see below), the Regulations provided only two limited exceptions allowing SBICs to structure investments utilizing a passive small business intermediary: (1) a holding company exemption under which an SBIC could structure an investment in a small business through one or two levels of passive intermediaries, but only if the top level passive business (in which the SBIC directly invested) owns at least 50% (directly, or indirectly through a second lower passive business) of the outstanding voting securities of the operating small business; and (2) a blocker company exemption under which a partnership SBIC, with prior SBA approval, could finance a small business through a passive, wholly-owned C-corporation formed by the SBIC if a direct financing would otherwise cause the SBIC’s investors to incur Unrelated Business Taxable Income (“UBTI”).

On December 28, 2016, the U.S. Small Business Administration (“SBA”) published a final rule proposing to amend its regulations regarding SBIC investments in passive businesses, to expand the existing exceptions to the passive business prohibition. The final rule originally had an effective date of January 27, 2017. But on January 26, the SBA delayed the effective date to March 21, 2017. The SBA further delayed the effective date to May 20, and again to August 18, when the Agency withdrew the final rule proposed on December 28, 2016, and replaced it with a new amended version which expands permitted investments in passive businesses, provides clarifications regarding such investments and adds certain requirements related to SBA’s oversight of such investments. That Final Rule became effective as of September 18, 2017 (the “Final Rule”).

#### STRUCTURING

##### *Investing in a holding company*

The holding company exception under the Final Rule now permits an SBIC to form and/or finance a passive business intermediary that will either pass substantially all the SBIC proceeds through to, or use substantially all the proceeds to acquire, one or more non-passive subsidiary operating small businesses. This is a technical change from the prior rule, which did not expressly permit the SBIC to form the holding company intermediary being financed, and did not permit the use of proceeds to acquire the eligible operating company. The Final Rule maintains the existing definition of a “subsidiary company” as an operating company in which the financed passive business directly or indirectly owns at least 50% of the outstanding voting securities, and also maintains the original requirement that an SBIC may not structure a financing through more than two passive intermediaries.

### ***Blocker entities formed by an SBIC***

The blocker exception under the Final Rule now permits the formation by an SBIC of one or more wholly-owned blocker entities, which may be either a corporation or a limited liability company that elects to be taxed as a corporation. Such a blocker entity may only be used if its sole purpose is to provide financing to one or more eligible unincorporated small businesses (i.e., pass-through entities for income tax purposes), and if a direct financing to such small businesses would cause any of the SBIC's investors to incur UBTI, or effectively connected income ("ECI") to foreign investors. This is a change from the prior rule, which only allowed the use of a corporation (not an LLC) as a blocker entity, and which was only permitted in situations that would result in UBTI (not ECI). However, the existing restriction to using only one or two passive intermediaries remains in place. The blocker intermediary must provide financing either directly to one or more eligible small business operating companies, or indirectly through a passive business that passes substantially all the proceeds directly to, or uses the proceeds to acquire, one or more eligible subsidiary operating companies. In addition, the Final Rule removed the requirement that an SBIC must seek prior SBA approval to make use of a blocker entity, and instead requires only a certification by the SBIC on the related portfolio financing report as to compliance with the requirements of the exemption, thus providing SBICs with greater flexibility to incorporate blocker entities as needed within the time constraints of a financing transaction.

### **TECHNICAL AND CLARIFYING CHANGES**

In addition to the above revisions to the existing passive business rule, the Final Rule includes some additional conditions for permitted passive business financings. For the purposes of the requirement that "substantially all" of the proceeds of a financing using either the holding company exemption or the blocker entity exemption pass directly to, or are used to acquire, one or more non-passive operating small businesses, the Final Rule defines the phrase "substantially all" to mean at least 99% of the proceeds, after deducting permitted application fees, closing fees and expense reimbursements.

The Final Rule also requires that the total amount of permitted fees charged to both passive and non-passive businesses in connection with the financing may not exceed fees that would have been charged if no passive businesses were used in structuring the financing. Further, the Final Rule requires that any such fees received by an SBIC's Associate (as defined by SBA Regulations), including the fund's managers, must be paid to the SBIC in cash within 30 days of the receipt of such fees, and does not provide for a dollar-for-dollar offset to the management fee paid by the SBIC, which would otherwise be permitted pursuant to SBA's TechNote 7A in a financing that did not involve a passive business. And in an effort to ensure the SBA will have necessary access to information and records regarding both the passive and non-passive businesses, the Final Rule also includes a provision clarifying that each passive and non-passive business included in the financing will be defined as a Portfolio Concern under the Act which must provide certain information required by SBA.

SBA's Portfolio Financing Report (SBA Form 1031) was also amended by the Final Rule to provide for reporting on both passive and non-passive entities. The new Form 1031 will require an SBIC to state whether a passive business is being used in the financing and, if so, provide the name and employer identification number of each such passive business. The SBIC must also provide additional information describing the structure, ownership and flow of funds among the passive and non-passive businesses and, if using the blocker entity exemption, the qualifying basis for using a blocker entity.