

Passive Business Rule

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October 19, 2017

Delayed, Withdrawn and Amended –What it Means for You

Excerpt:

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”).

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