

SMALL BUSINESS INVESTMENT CORRECTIONS ACT OF 2000

MARCH 14, 2000.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. TALENT, from the Committee on Small Business,
submitted the following

R E P O R T

[To accompany H.R. 3845]

[Including cost estimate of the Congressional Budget Office]

The Committee on Small Business, to whom was referred the bill (H.R. 3845) to make corrections to the Small Business Investment Act of 1958, and for other purposes, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

PURPOSE

The purpose of H.R. 3845 is to amend the Small Business Investment Act (the Act) to make changes in the Small Business Investment Company (SBIC) program at the Small Business Administration (SBA), commonly known as the SBIC program. H.R. 3845 contains four technical changes to improve the program and correct problems brought to the Committee's attention through the oversight process.

H.R. 3845 modifies the definition of control for SBIC investment in small businesses, eliminating a cumbersome five prong test and setting a clear statutory standard. H.R. 3845 will also modify the definition of long term investment under the Act, changing it from five years to one year, in order to harmonize that definition with accepted business practice and the tax and banking laws. Third, the bill allows the Administration to adjust the subsidy fee for the SBIC program to maintain the subsidy rate of the program at zero. Finally, the bill makes a change to the distribution language in the Act, allowing SBICs more flexibility in making distributions to their investors and will simplify the accounting and tax procedures at SBICs.

NEED FOR LEGISLATION

Definition of small business concern

SBA regulations currently prohibit an SBIC from owning a controlling interest in the voting stock of a small business or otherwise exercising control to the small business.

These regulations were put in place to ensure that SBICs did not become holding companies and to protect small business from over aggressive investments. During the life of the program several exceptions have been put in place recognizing the reality of equity investment. These include control for a start-up company, when a major investment is undertaken, for a troubled company, breach of agreement, and most recently for those businesses that are located in low and moderate income area (LMIs). Through the administering and oversight of these regulations the Committee believes the result has been to create a complicated and sometimes burdensome process for both SBA and SBICs.

While the intent of the regulation was the protection of small business it has resulted in keeping parties to an SBIC investment from structuring the investment in ways that may be most reasonable and acceptable from both operating and market perspective. The Committee made these changes recognizing the reality of venture capital investment, however the amendment is not intended to foster SBICs becoming holding companies for operating small business concerns. In today's venture capital world venture funds may act as incubators of business ideas by creating and capitalizing small businesses to nurture technology in the early stages of its development. In such cases SBICs may need to create, capitalize and operate small business concerns in the early years.

Furthermore, the Gramm-Leach-Bliley Bank Modernization Act—which grants banks authority to conduct venture capital operations without an SBIC license—does not prohibit control. To the contrary, it explicitly permits control during the investment period. The proposed amendment would make the Small Business Investment Act consistent with the new banking law and would serve as an incentive for banks to retain their SBIC operations—to the benefit of U.S. small businesses.

Definition of long term

The term “long-term” as found in Section 102 of the Act has been interpreted to mean a period of time equal to a minimum of five years for all SBIC investments other than those made in “Disadvantaged Businesses.” For the latter, the minimum period is four years.

This interpretation does not allow SBICs and small businesses to fashion investment agreements that are flexible enough to meet the needs of both parties in accordance with the dictates of the commercial marketplace.

This interpretation has no counterpart in any other area of business commerce. To the contrary, Generally Accepted Accounting Principles (GAAP) define “long-term” as any period of time greater than one year in duration. Likewise, tax law defines “long-term” for capital gains purposes as a period greater than one year. The pro-

posed amendment would make SBIC law consistent with GAAP and tax law and apply the same standard for all SBIC investments.

The Gramm-Leach-Bliley Bank Modernization Act—which gives banks authority to conduct venture capital operations without an SBIC license—places no restrictions on the period of time for investments. The proposed amendment will be consistent with the new bank law and would serve as an important incentive for banks to retain their SBIC operations—to the benefit of U.S. small businesses seeking financing. Without the amendment, many banks may choose to operate all their venture capital operations outside the SBIC program—to the detriment of small businesses served by the SBIC program.

Subsidy fees

An additional 1 percent interest obligation was imposed on SBICs in 1996 in order to reduce the Small Business Administration's appropriated cost, as determined by the Administration's subsidy model, for supporting the SBIC program. Since then changes in the program coupled with a stricter examination and licensing program at SBA have significantly reduced the subsidy cost of both the Debenture and Participating Securities programs. At least part of the 1 percent in additional interest is no longer required in the Debenture program to keep the subsidy rate at zero. The same may soon be true for the Participating Securities program as well. In fact, current estimates show that the 1 percent fee is overcharging the SBICs (and their small business clients), resulting in a hidden tax on the program.

Changing the law as proposed would allow the Administration to adjust the additional interest and prioritized payment rates annually based on annual subsidy rate calculations. A similar approach is already in place for the SBA's 504 loan program which operates at no cost to the taxpayer and has consistently reduced its fees.

Distribution

Under current law, SBICs may make prioritized payment distributions, profit distributions, and other optional distributions (e.g., distributions of capital on any date with prior SBA approval). Tax distributions, however, may only be made at the end of calendar year quarters.

The practical impact of this restriction is that SBICs are forced to either delay otherwise permitted interim distributions (that would include tax distributions) to the end of a quarter or split their distributions into two distributions—tax distributions (made at the end of a quarter) and all other distributions (made at any time during a quarter).

Postponing an entire distribution to the end of a quarter has negative cash flow and internal rate of return (IRR) implications for SBICs. Consequently, most SBICs will opt to split their distributions. Splitting distributions requires the preparation, submission, and SBA review of two sets of documents when one would otherwise suffice. This results in inefficient use of both SBA and SBIC time and resources.

The proposed amendment is technical in nature and will have no substantive impact on the SBIC program. However, it will save

time and expense for both SBA and SBICs by eliminating duplicative filings and inefficient use of SBA resources.

COMMITTEE ACTION

Hearing on the SBA budget and legislative proposals

On March 1, 2000, at 10:00 a.m., the Committee on Small Business convened a hearing to discuss the Administration's budget proposal for the SBA for fiscal year 2001 and legislative proposals. The Committee received testimony from five witnesses: Hon. Aida Alvarez, Administrator of the Small Business Administration; Mr. Anthony Wilkinson, President of the National Association of Government Guaranteed Lenders; Mr. Lee Mercer, President of the National Association of Small Business Investment Companies; Mr. Woody McCutchen, Executive Director of the Association of Small business Development Centers; Ms. Caroline Hayashi, representing the Association for Enterprise Opportunity; and Mr. John Geigel, Vice President for Government Relations of the National Association of Development Companies.

During his testimony Mr. Mercer discussed the changes included in H.R. 3845 and asked that the Committee consider legislation addressing these concerns.

Consideration of H.R. 3845

At 10 a.m. on March 9, 2000, the Committee on Small Business met to consider and report H.R. 3843 and H.R. 3845. After consideration of H.R. 3843, Chairman Talent asked unanimous consent that H.R. 3845 be considered as read and open for amendment at any point. No amendments were offered to H.R. 3845. The Chairman then moved the bill be reported, and at 10:16 a.m., by a voice vote, a quorum being present, the Committee passed H.R. 3845 and ordered it reported.

SECTION-BY-SECTION ANALYSIS

Section 1. Short title

Section 2. Definitions

(a) Small Business Concern.—Inserts the following language in section 103(5)(A)(i) of the Small Business Investment Act—“regardless of the allocation of control during the investment period under any investment agreement between the business concern and the entity making the investment”. This phrase clarifies that a venture capital investment agreement from an SBIC may cause a change in control of a small business, but that such a change will not affect the eligibility of the small business concern. The Committee does not intend that SBICs become holding companies hence the language references the period of the investment agreement. Further, the Committee retains the authority for SBIC examinations to inquire into “illegal control” by SBICs, though the committee expects such control to be that exercised outside an investment agreement.

(b) Long term.—Inserts the following paragraph in section 103 of the Small Business Investment Act:

“(17) the term long term, when used in connection with equity capital or loan funds invested in any small business concern or smaller enterprise, means any period of time not less than 1 year.”

The language changes the definition of a long term investment to harmonize it with the tax and banking laws.

Section 3. Subsidy fees

This provision amends sections 303(b) and 303(g)(2) of the Small Business Investment Act to allow the Administration to adjust the fee assessed on debentures and participating securities up to a maximum of one percent. The fee will be adjusted to keep the subsidy cost of the programs at zero or as close as possible to zero.

Section 4. Distributions

This section amends section 303(g)(8) of the Small Business Investment Act in order to allow SBICs to make distributions at any time during a calendar quarter based on the maximum estimated tax liability.

Section 5. Conforming amendment

CBO ESTIMATE

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, March 14, 2000.

Hon. JAMES M. TALENT,
*Chairman, Committee on Small Business,
House of Representatives, Washington, DC.*

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate for H.R. 3845, the Small Business Investment Corrections Act of 2000.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contact is Mark Hadley.

Sincerely,

BARRY B. ANDERSON
(For Dan L. Crippen, Director).

Enclosure.

CBO estimates that enactment of H.R. 3845 would cost about \$50 million in 2000 because it could end the collection of fees currently charged by the Small business Administration (SBA) for loan guarantees made to private venture capital firms. The bill could reduce offsetting receipts (a form of direct spending); therefore, pay-as-you-go procedures would apply. H.R. 3845 contains no intergovernmental or private-sector mandates as defined in the Unfunded Mandates Reform Act and would impose no costs on state, local, or tribal governments.

Through two Small Business Investment Company (SBIC) programs, SBA guarantees 10-year loans made to venture capital firms. To offset the subsidy cost of these guarantees, SBA charges venture capital firms that participate in the program a fee of 1 percent of the loan amount each year. Based on information from SBA and the Office of Management and Budget, CBO estimates that

there will be about \$6 billion of guaranteed loan balances at the end of 2000, resulting in the collection of about 460 million in fees in 2000.

H.R. 3845 would require SBA to reduce the 1 percent fee if the subsidy cost of these programs would otherwise be less than zero. The subsidy cost of a loan guarantee is the estimated long-term cost to the government, calculated on a net present value basis and excludes administrative costs. For fiscal year 2000, the estimated subsidy rate is 1.8 percent for one of the SBIC programs and zero for the other. If SBA reestimates the subsidy cost of these loan guarantees to be less than zero (that is, a “negative subsidy”), H.R. 3845 would require the agency to reduce the fees by reducing the possibility of recognizing any negative subsidies. Based on the likelihood that the subsidy rate for these programs could be less than zero, CBO estimates that enacting this provision would reduce future offsetting receipts. The estimated cost of \$50 million represents the present value of fees that could be eliminated by the bill. Such fees would otherwise be collected annually over the remaining term of the \$6 billion in loan guarantees.

The CBO staff contact is Mark Hadley. The estimate was approved by Peter H. Fontaine, Deputy Assistant Director for Budget Analysis.

COMMITTEE ESTIMATE OF COSTS

Pursuant to the Congressional Budget Act of 1974, the Committee estimates that the amendments to the Small Business Investment Act contained in H.R. 3845 will not increase discretionary spending over the next five fiscal years. The Committee also estimates that H.R. 3845 will increase direct spending by \$50 million, as currently drafted, when applied to previous cohorts of SBIC loans. This estimate concurs with Congressional Budget Office (CBO) estimates.

Furthermore, pursuant to clause 3(d)(2)(A) of rule XIII of the Rules of the House of Representatives, the Committee estimates that implementation of H.R. 3845 will not significantly increase other administrative costs.

OVERSIGHT FINDINGS

In accordance with clause 4(c)(2) of rule X of the Rules of the House of Representatives, the Committee states that no oversight findings or recommendation have been made by the Committee on Government Reform with respect to the subject matter contained in H.R. 3845.

In accordance with clause (2)(b)(1) of rule x of the Rules of the House of Representatives, the oversight findings and recommendations of the Committee on Small Business with respect to the subject matter contained in H.R. 3845 are incorporated into the descriptive portions of this report.

STATEMENT OF CONSTITUTIONAL AUTHORITY

Pursuant to clause 3(d)(1) of rule XIII of the Rules of the House of Representatives, the Committee finds the authority for this legis-

lation in Article I, Section 8, clause 18, of the Constitution of the United States.

CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3(e) of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman):

SMALL BUSINESS INVESTMENT ACT OF 1958

* * * * *

TITLE I—SHORT TITLE, STATEMENT OF POLICY, AND DEFINITIONS

* * * * *

DEFINITIONS

SEC. 103. As used in this Act—

(1) * * *

* * * * *

(5) the term “small-business concern” shall have the same meaning as in the Small Business Act, except that, for purposes of this Act—

(A) an investment by a venture capital firm, investment company (including a small business investment company) employee welfare benefit plan or pension plan, or trust, foundation, or endowment that is exempt from Federal income taxation—

(i) shall not cause a business concern to be deemed not independently owned and operated *regardless of the allocation of control during the investment period under any investment agreement between the business concern and the entity making the investment;*

* * * * *

(15) the term “member” means, with respect to a licensee that is a limited liability company, a holder of an ownership interest or a person otherwise admitted to membership in the limited liability company; **[and]**

(16) the term “limited liability company” means a business entity that is organized and operating in accordance with a State limited liability company statute approved by the Administration~~[\.]~~; *and*

(17) *the term “long term”, when used in connection with equity capital or loan funds invested in any small business concern or smaller enterprise, means any period of time not less than 1 year.*

* * * * *

TITLE III—SMALL BUSINESS INVESTMENT COMPANIES

* * * * *

BORROWING POWER

SEC. 303. (a) * * *

(b) To encourage the formation and growth of small business investment companies the Administration is authorized when authorized in appropriation Acts, to purchase, or to guarantee the timely payment of all principal and interest as scheduled on, debentures or participating securities issued by such companies. Such purchases or guarantees may be made by the Administration on such terms and conditions as it deems appropriate, pursuant to regulations issued by the Administration. The full faith and credit of the United States is pledged to the payment of all amounts which may be required to be paid under any guarantee under this subsection. Debentures purchased or guaranteed by the Administration under this subsection shall be subordinate to any other debenture bonds, promissory notes, or other debts and obligations of such companies, unless the Administration in its exercise of reasonable investment prudence and in considering the financial soundness of such company determines otherwise. Such debentures may be issued for a term of not to exceed fifteen years and shall bear interest at a rate not less than a rate determined by the Secretary of the Treasury taking into consideration the current average market yield on outstanding marketable obligations of the United States with remaining periods to maturity comparable to the average maturities on such debentures, adjusted to the nearest one-eighth of 1 per centum, [plus an additional charge of 1 percent per annum which shall be paid to and retained by the Administration] *plus an additional charge, in an amount established annually by the Administration, of not more than 1 percent per year as necessary to reduce to zero the cost (as defined in section 502 of the Federal Credit Reform Act of 1990 (2 U.S.C. 661a)) to the Administration of purchasing and guaranteeing debentures under this Act, which shall be paid to and retained by the Administration.* The debentures or participating securities shall also contain such other terms as the Administration may fix, and shall be subject to the following restrictions and limitations:

(1) * * *

* * * * *

(g) In order to encourage small business investment companies to provide equity capital to small businesses, the Administration is authorized to guarantee the payment of the redemption price and prioritized payments on participating securities issued by such companies which are licensed pursuant to section 301(c) of this Act, and a trust or a pool acting on behalf of the Administration is authorized to purchase such securities. Such guarantees and purchases shall be made on such terms and conditions as the Administration shall establish by regulation. For purposes of this section, (A) the term "participating securities" includes preferred stock, a preferred limited partnership interest or a similar instrument, including debentures under the terms of which interest is payable only to the extent of earnings and (B) the term "prioritized payments" includes dividends on stock, interest on qualifying debentures, or priority returns on preferred limited partnership interests which are paid only to the extent of earnings. Participating securi-

ties guaranteed under this subsection shall be subject to the following restrictions and limitations, in addition to such other restrictions and limitations as the Administration may determine:

(1) * * *

(2) Prioritized payments on participating securities shall be preferred and cumulative and payable out of the retained earnings available for distribution, as defined by the Administration, of the issuing company at a rate determined by the Secretary of the Treasury taking into consideration the current average market yield on outstanding marketable obligations of the United States with remaining periods to maturity comparable to the average maturities on such securities, adjusted to the nearest one-eighth of 1 percent, **[plus an additional charge of 1 percent per annum which shall be paid to and retained by the Administration]** *plus an additional charge, in an amount established annually by the Administration, of not more than 1 percent per year as necessary to reduce to zero the cost (as defined in section 502 of the Federal Credit Reform Act of 1990 (2 U.S.C. 661a)) to the Administration of purchasing and guaranteeing participating securities under this Act, which shall be paid to and retained by the Administration.*

* * * * *

(8) Notwithstanding paragraph (9), if a company is operating as a limited partnership or as a subchapter **[s]** S corporation or an equivalent pass-through entity for tax purposes and if there are no accumulated and unpaid prioritized payments, the company may make annual distributions to the partners, shareholders, or members in amounts not greater than each partner's, shareholder's, or member's maximum tax liability. For purposes of this paragraph, the term "maximum tax liability" means the amount of income allocated to each partner, shareholder, or member (including an allocation to the Administration as if it were a taxpayer) for Federal income tax purposes in the income tax return filed or to be filed by the company with respect to the fiscal year of the company immediately preceding such distribution, multiplied by the highest combined marginal Federal and State income tax rates for corporations or individuals, whichever is higher, on each type of income included in such return. For purposes of this paragraph, the term "State income tax" means the income tax of the State where the company's principal place of business is located. A company may also elect to make a distribution under this paragraph at **[the end of any calendar quarter based on a quarterly]** *any time during any calendar quarter based on an estimate of the maximum tax liability.* If a company makes 1 or more **[quarterly distributions for a calendar year,]** *interim distributions for a calendar year,* and the aggregate amount of those distributions exceeds the maximum amount that the company could have distributed based on a single annual computation, any subsequent distribution by the company under this paragraph shall be reduced by an amount equal to the excess amount distributed.

* * * * *

EXAMINATIONS AND INVESTIGATIONS

SEC. 310. (a) * * *

* * * * *

(c) Each small business investment company shall be examined at least every two years in such detail so as to determine whether or not—

(1) * * *

* * * * *

(4) it has made investments in small businesses for not less than **five years** *1 year*;

* * * * *

