

SMALL BUSINESS INVESTMENT COMPANY TECHNICAL
CORRECTIONS ACT OF 1998

MARCH 17, 1998.—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

REPORT

[To accompany H.R. 3412]

[Including cost estimate of the Congressional Budget Office]

The Committee on Small Business, to whom was referred the bill (H.R. 3412) to amend and make technical corrections in title III of the Small Business Investment Act, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

The amendment (stated in terms of the page and line numbers of the introduced bill) is as follows:

On page 2, line 11, strike “revenues” and insert “income” and on line 12 strike “revenue” both places it appears and insert “income”.

PURPOSE

The purpose of H.R. 3412 is make certain technical amendments to Title III of the Small Business Investment Act of 1958. This title authorizes the activities of the Small Business Investment Company program. Small Business Investment Companies (SBICs) are venture capital firms licensed by the Small Business Administration that use SBA guarantees to leverage private capital for investment in small businesses.

The technical corrections proposed by H.R. 3412 will improve the flexibility of the SBIC program and allow improved access to this program by small businesses.

NEED FOR LEGISLATION

Congress revamped the SBIC program in the 103d Congress to provide for a new form of leverage geared specifically towards eq-

uity investment in small businesses. Over the ensuing years, as the new program has become established, certain deficiencies have come to light; in addition, certain statutory provisions have become obsolete.

Moreover, the nature of the SBIC industry has changed. The result is a participating securities industry made up primarily of smaller SBICs. The fact that these smaller SBICs are dominating the program points to shifting dynamics in the SBIC program. Smaller, start-up investments are more typical and, therefore, the demand for leverage has shifted to smaller individual placements.

H.R. 3412 seeks to correct these deficiencies, and remove provisions that may produce confusion due to changes in law and the character of the SBIC program. Under H.R. 3412, a provision in the Small Business Investment Act that reserves leverage for smaller SBICs will be repealed. Changes in SBA policy regarding applications for leverage, statutory changes in the availability of commitments for SBICs, and the makeup of the industry present the possibility that that provision may, in fact, create conflicts and confusion.

H.R. 3412 modifies a test for determining the eligibility of small businesses for SBIC financing. Current statutory language does not account for small businesses organized in pass-through tax structures such as S corporations, limited liability companies, and certain partnerships. These organizations do not pay taxes at the enterprise level but instead pass through income and the ensuing tax liabilities to their partners and shareholders. Consequently, many of these small businesses face difficulties when the income test is applied to them, and are often declared ineligible for financing they should receive.

Finally, H.R. 3412 will allow the SBA greater flexibility in issuing trust certificates to finance the SBIC program's investments in small businesses. Current law allows fundings to be issued every six months or more frequently. This inhibits the ability of the SBICs and the SBA to form pools of certificates that are large enough to generate serious investor interest. Allowing more time between fundings will permit SBA and the industry to form larger pools for sale in the market, thereby increasing investor interest and improving the interest rates for the small businesses financed.

COMMITTEE ACTION

On Thursday, March 12, 1998, the Committee on Small Business held a hearing to consider the provisions of H.R. 3412. Testifying at the hearing was Mr. Lee Mercer, President of the National Association of Small Business Investment Companies. Mr. Mercer testified to the beneficial effects that H.R. 3412 would have on the SBIC program. He recognized the improvements in management that have occurred in the program over recent years and recommended the corrections contained in H.R. 3412. Mr. Mercer explained the three provisions and the effect they would have in detail.

Chairman Talent questioned Mr. Mercer regarding the concern that the provision that removed the reserve of leverage for smaller SBICs might impair access to leverage for those firms. Mr. Mercer

responded that his organization, which is composed primarily of smaller SBICs, endorsed the provision. He also stated that demands for leverage in the participating securities were generally for small individual placements rather than any single large investments that would seriously deplete funding. Ms. Velázquez then questioned Mr. Mercer about the correction of the after-tax income test, and asked if he could supply any specific firms who had been denied eligibility due to the current test. Mr. Mercer stated that he could not name any specific firms but that he had heard of several such firms.

Ms. Velázquez, Mr. Davis and Mrs. Kelly then asked Mr. Mercer several questions concerning the SBIC industry's efforts to attract more minority and women-owned businesses for financing assistance. Mr. Mercer described a number of initiatives that his organization had started to achieve those ends. Ms. Velázquez also requested that Mr. Mercer and his organization develop and provide an outreach program for minority and women-owned businesses.

Immediately after the hearing, Chairman Talent called the Committee to order for the purpose of marking up and reporting H.R. 3412. The bill was introduced, considered as read, and opened for amendment. Chairman Talent offered a single technical amendment which was accepted by voice vote. The motion was then made to report H.R. 3412, as amended. By voice vote, a quorum being present, the Committee passed the bill, H.R. 3412, and ordered it reported.

SECTION-BY-SECTION ANALYSIS

SECTION 1. SHORT TITLE.

Designates the bill as "The Small Business Investment Company Technical Corrections Act of 1998".

SECTION 2. TECHNICAL CORRECTIONS.

(1) This paragraph removes subparagraph (13) of Section 303(g) of the Small Business Investment Act (15 U.S.C. 683(g)). That provision reserves 50% of participating securities leverage for Small Business Investment Companies with private capital of less than \$20 million until the fourth fiscal quarter. While the Committee continues to be interested that all SBICs have access to the funding needed to complete their investments, we also recognize that this provision is no longer necessary. Only 12 of the 60 SBICs in the participating leverage program have more than \$20 million in private capital, and the original concern that a few large SBICs would dominate the program has proved unfounded. It appears that most SBIC equity placements are in smaller early-stage businesses and consequently most participating securities SBICs are established as small funds.

(2) This paragraph establishes a test for small businesses formed as tax "pass-through" entities such as S corporations, or limited liability companies. Such businesses will have their small business investment eligibility determined by multiplying their net income by the combined federal and state corporate tax rate and then subtracting the result from their net income. That result will serve as the small business' estimated "after-tax income" for the purpose of

determining eligibility. This removes an uncertainty in the statute that meant a C corporation with as much as \$9 million in pretax income could be a small business but a pass-through S corporation with \$6,000,001 in income was ineligible.

(3) The final paragraph changes Section 320 of the Small Business Investment Act to allow issuance of Small Business Administration-backed trust certificates not less than every twelve months rather than the current standard of every six months. SBA would retain the discretion to issue guarantees and trust certificates at shorter intervals if appropriate. The change will give SBA increased flexibility in negotiating the terms and costs associated with the placement of certificates, either by contract or public offering. This will ultimately benefit the small businesses seeking financing since the rates sought by SBICs are reflected in the rates charged to small businesses.

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, March 16, 1998.

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. 3412, the Small Business Investment Company Technical Corrections Act of 1998.

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

Sincerely,

JAMES L. BLUM,
(For June E. O'Neill, Director).

Enclosure.

CONGRESSIONAL BUDGET OFFICE COST ESTIMATE

H.R. 3412—Small Business Investment Company Technical Corrections Act of 1998

CBO estimates that enacting this bill would not have a significant impact on the federal budget. Because H.R. 3412 would not affect direct spending or receipts, pay-as-you-go procedures would not apply. H.R. 3412 contains no intergovernmental or private-sector mandates as defined in the Unfunded Mandates Reform Act of 1995 and would not affect the budgets of state, local, or tribal governments.

H.R. 3412 would make a number of technical corrections to the Small Business Investment Act of 1958. It would allow the Small Business Administration (SBA) to allocate the appropriations available to fund small business investment companies (SBICs) more evenly over the course of a year by eliminating a provision in current law that reserves funds for smaller SBICs until the last quarter of the fiscal year. It also would allow a more accurate comparison of the revenues of small businesses seeking eligibility for the SBIC program by requiring SBA to compare a firm's revenues assuming that it has paid all required income taxes. (Certain corporate structures, such as "S" corporations, pass all income through

to the stockholders. This makes comparing revenues with firms that do not pass through income, but instead pay taxes at the corporate level, misleading.) Finally, H.R. 3412 would give SBA more flexibility in issuing certificates that help finance SBIC activities by increasing the minimum placement period for public offerings from 6 months to 12 months.

The Congress annually limits total SBA commitments for financing SBICs through the appropriation process. CBO expects that enacting H.R. 3412 would affect SBA procedures and might change the mix of eligibility for participating in the SBIC programs, but would result in no significant additional cost to the federal government.

The CBO staff contact for this estimate is Mary Maginniss. This estimate was approved by Robert A. Sunshine, Deputy Assistant Director for Budget Analysis.

STATEMENT OF CONSTITUTIONAL AUTHORITY

Pursuant to clause 2(1)(4) of rule XI of the Rules of the House of Representatives, the Committee finds the authority for this legislation in Article I, Section 8, Clause 18 of the Constitution of the United States.

OVERSIGHT FINDINGS

In accordance with clause 2(1)(3)(D) of rule XI of the Rules of the House of Representatives, the Committee states that no oversight findings or recommendations have been made by the Committee on Government Reform and Oversight with respect to the subject matter contained in H.R. 3412.

In accordance with clause 2(1)(3)(D) of rule XI 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. 3412 are incorporated into the descriptive portions of this report.

CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3 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 III—SMALL BUSINESS INVESTMENT COMPANIES

* * * * *

SEC. 303. (a) * * *

* * * * *

(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 securities 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) * * *

* * * * *

[(13) PARTICIPATING SECURITIES FOR SMALLER SMALL BUSINESS INVESTMENT COMPANIES.—

[(A) IN GENERAL.—Subject to the provisions of subparagraph (B), of the amount of the annual program level of participating securities approved in appropriations Acts, 50 percent shall be reserved for funding small business investment companies with private capital of not more than \$20,000,000.

[(B) EXCEPTION.—During the last quarter of each fiscal year, if the Administrator determines that there is a lack of qualified applicants with private capital of not more than \$20,000,000, the Administrator may utilize all or any part of the program level for securities reserved under subparagraph (A) for qualified applicants with private capital of more than \$20,000,000.]

* * * * *

MISCELLANEOUS

SEC. 308. (a) * * *

* * * * *

(j) For the purposes of sections 304 and 305, in a case in which an incorporated or unincorporated business is not required by law to pay Federal income taxes at the enterprise level but is required to pass income through to its shareholders or partners, an eligible small business or smaller enterprise may be determined by computing the after-tax income of such business by deducting from the net income an amount equal to the net income multiplied by the combined marginal Federal and State income tax rate for corporations.

* * * * *

PERIODIC ISSUANCE OF GUARANTEES AND TRUST CERTIFICATES

SEC. 320. The Administration shall issue guarantees under section 303 and trust certificates under section 319 at periodic intervals of not less than every **[6]** 12 months and shall do so at such shorter intervals as its deems appropriate, taking into consideration the amount and number of such guarantees or trust certificates.

* * * * *

