Articles + Publications | January 5, 2017

SBA Expands and Clarifies Ability of SBICS to Finance in Passive Businesses

WRITTEN BY

Christopher A. Rossi

New SBA rule affects the holding company and the blocker corporation exceptions for SBICs' financing passive businesses.

On December 28, the U.S. Small Business Administration (SBA) released a Final Rule modifying its regulations on the ability of a small business investment company (SBIC) to finance passive businesses. A business is considered to be "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. The mere receipt of payments such as dividends, rents, lease payments or royalties is not considered a regular and continuous business operation. SBICs are generally prohibited from financing passive businesses. However, the SBIC program regulations provide for two exceptions to this prohibition. The Final Rule expands and makes certain clarifications to these exceptions.

This Client Alert provides a summary of these two exceptions and describes how they have been modified by the Final Rule. The Final Rule is effective January 27, 2017.

Passive Business Investment Exceptions

The "Holding Company" Exception

The holding company exception currently permits an SBIC to structure a financing through up to two tiers of passive businesses (holding companies) so long as the holding company financed by the SBIC passes substantially all of the financing proceeds through to one or more "subsidiary companies" that are eligible small businesses and not themselves holding companies (operating companies). A "subsidiary company" is an operating company in which the financed holding company either:

- directly owns at least 50 percent of the outstanding voting securities, or
- indirectly owns at least 50 percent of the outstanding voting securities (by directly owning the outstanding voting securities of another holding company that is the direct owner of the outstanding voting securities of the operating company).

Thus, under the existing holding company exception, an SBIC can finance a holding company (Holdco 1) if Holdco 1 directly owns at least 50 percent of the outstanding voting securities of the operating company or if Holdco 1

©2026 Troutman Pepper Locke

directly owns a sufficient percentage of the outstanding voting securities of an intermediate holding company (Holdco 2) that would enable Holdco 1 to own indirectly through its ownership of Holdco 2 at least 50 percent of the outstanding voting securities of the operating company.

The Final Rule includes technical modifications to codify SBA's existing interpretation of the holding company exception to (1) permit an SBIC not only to finance a holding company in accordance with the exception, but also **to form** the holding company being financed and (2) enable a holding company not only to pass substantially all of the financing proceeds through to the operating company, but also to use substantially all of the financing proceeds **to acquire** the operating company either directly or indirectly through an intermediate holding company in which the holding company owns a sufficient percentage of the outstanding voting securities that would enable the holding company to own indirectly (through its ownership of the intermediate holding company) at least 50 percent of the outstanding voting securities of the operating company.

Figure 1 illustrates how an SBIC could structure the financing of an operating company under the holding company exception:

Figure 1

The "Blocker Corporation" Exception

The blocker corporation exception currently permits an SBIC, with SBA's prior written approval, to finance an eligible unincorporated small business through a passive business that is organized as a corporation and wholly owned by the SBIC, but only if a direct financing of the small business by the SBIC would cause one or more of the SBIC's investors to incur "unrelated business taxable income" (UBTI) under section 511 of the Internal Revenue Code. The passive business formed under this exception is typically referred to as a "blocker corporation."

The Final Rule modifies the blocker corporation exception by:

- Permitting the blocker corporation (referred to as a "blocker entity" in the Final Rule) to be organized as a corporation or limited liability company that elects to be taxed as a corporation for federal income tax purposes
- Replacing the requirement for an SBIC to obtain SBA prior written approval before forming a blocker entity with a requirement that the SBIC prepare and maintain in its files for review by SBA a certification that the blocker entity was formed in accordance with the exception
- Expanding the circumstances under which an SBIC may form a blocker entity.

Under the Final Rule, an SBIC will be permitted to finance, without prior SBA approval, one or more eligible unincorporated small businesses through one or more blocker entities wholly owned by the SBIC if a direct financing of the small business by the SBIC would cause (1) any of the SBIC's investors to incur UBTI, (2) any of the SBIC's foreign investors to incur "effectively connected income" under sections 871 and 882 of the Internal Revenue Code or (3) any of the SBIC's investors that have elected to be taxed as a regulated investment company (*e.g.*, business development companies) to receive (or be deemed to receive) gross income that does not qualify under section 851(b)(2) of the Internal Revenue Code.

©2026 Troutman Pepper Locke

A wholly owned blocker entity financed by an SBIC under the Final Rule is permitted to provide a financing directly to:

- One or more operating companies
- A holding company that passes substantially all of the financing proceeds directly to (or uses substantially all of the financing proceeds to acquire) one or more operating companies in which the holding company directly owns (or will own as a result of the financing) at least 50 percent of the outstanding voting securities.

Figure 2 illustrates how an SBIC could structure the financing of an operating company under the blocker corporation exception:

Figure 2

SBA specifically did not adopt industry comments that would have permitted an SBIC to finance a wholly owned blocker entity under the blocker corporation exception and then have that blocker entity finance an operating company through a two-tier holding company structure in accordance with the holding company exception. Thus, an SBIC that forms a wholly owned blocker entity in accordance with the blocker corporation exception will not be permitted to provide financing to a holding company that is more than one tier removed from the operating company.

New Conditions to Availability of These Exceptions

The Final Rule incorporates the following additional conditions to an SBIC's ability to structure financings under the holding company and the blocker corporation exceptions.

Meaning of "Substantially All"

The Final Rule defines "substantially all" of the financing proceeds to mean at least 99 percent of the financing proceeds after deduction of actual application fees, closing fees and expense reimbursements to the extent the fees and reimbursements are permitted to be charged under SBIC program regulations.

Maximum Amount of Financing and Management Fees

The Final Rule clarifies that if an SBIC or any of the SBIC's "associates" charge financing or management fees, then the total amount of all fees so charged to all holding companies and operating companies that are part of the same financing cannot exceed the fees that would have been permitted if the financing had been provided directly to the operating company.

Requirement for an SBIC's "Associates" to Pay Over Fees Received by Them to the SBIC

If an "associate" of an SBIC receives any financing or management fees, then the associate is required to pay over these fees to the SBIC in cash within 30 days of the associate's receipt of the fees.

The Final Rule's new pay-over condition treats fees received by an SBIC's associate in a financing completed by the SBIC utilizing the holding company or the blocker corporation exceptions differently than the manner in which those fees would be treated if the SBIC had completed the financing directly to the operating company without using either exception. This difference lies in the requirement under SBA's TechNote 7A (which provides SBA's policy guidelines concerning allowable management fees for leveraged SBICs) that any such fees received by an SBIC's associates *either* be paid over to the SBIC in cash *or* treated as a dollar-for-dollar offset to the management fee paid by the SBIC. Moreover, TechNote 7A includes an exception to this requirement for investment banking fees received by an SBIC's associate who is an SEC-registered broker-dealer regularly engaged in the business of providing investment banking services. This investment banking exception is not specifically recognized in the Final Rule's new pay-over condition. Thus, financings made by SBICs through holding companies are on a different footing than financings made directly because fees received by an SBIC's associate in financings made directly can be offset against the management fee paid by the SBIC, while fees received in financings made through holding companies must be paid over in cash by the associate to the SBIC.

In implementing the Final Rule, SBA did not accept the industry's comment that the pay-over condition was unnecessary in light of TechNote 7A and because most SBICs addressed the issue through a dollar-for-dollar offset to the management fee paid by the SBIC for tax reasons. SBA did not adopt the industry's comment because of SBA's views concerning the difficulty in monitoring investments utilizing holding company structures and identifying fees associated with each holding company in addition to those paid by the operating company.

Extension of the Term 'Portfolio Concern' to Passive Businesses

The Final Rule modifies the term "Portfolio Concern" to clarify that all holding companies and operating companies included in a financing are Portfolio Concerns and, therefore, subject to SBIC program regulations concerning:

- Certain recordkeeping, information and reporting requirements of, and with respect to, Portfolio Concerns
- An SBIC's designation of its associates to serve as officers, directors or other participants in the management of a Portfolio Concern
- The manner in which a change in a Portfolio Concern's size or activity affects the SBIC's ability to continue to hold and make investments in the Portfolio Concern
- Restrictions on the terms under which an SBIC is permitted to redeem equity securities of a Portfolio Concern.

Changes to SBA Form 1031

The Final Rule implements changes to SBA's Form 1031 (Portfolio Financing Report) that must be submitted by SBICs to SBA within 30 days after the completion of each financing. These changes do the following:

- Clarify that SBICs should report data on the operating company when reporting information on financings using holding companies in Part A, Part B and, with the exception of the amount of financing dollars in Question 29, Part C of Form 1031 (for Question 29 of Part C, the amount of the financing dollars provided by the SBIC should be included regardless of whether the financing dollars were provided directly or indirectly to the operating company)
- Incorporate an additional question regarding whether the financing utilizes one or more holding companies as part of the financing

- Require SBICs to upload an information file in PDF format that:
  - Identifies whether the SBIC is utilizing the holding company or the blocker corporation exceptions and, if so, the name and employer ID number for each holding company used in the financing
  - Describes the financing structure, including the flow of money between the SBIC and the holding companies that receive the proceeds (including amounts and the types of securities between each entity) and the ownership from the SBIC through each entity to the operating company
  - Identifies whether the financing is an SBIC-identified impact investment or an SBA-identified impact investment (for Impact SBICs).

Technical Changes

The Final Rule also incorporates several technical changes that are unrelated to the passive business SBIC program regulations. These technical changes:

- Implement SBA's current oversight practices that allow the minimum $5 million regulatory capital and $2.5 million leveragable capital requirements for SBICs to be less if the reductions are performed in accordance with an SBA-approved wind-up plan
- Reflect the increase in the maximum amount of SBA leverage available to SBICs under common control from $225 million to $350 million that was implemented by congressional legislation passed in December 2015.

A more detailed description of the SBIC Program is available in Pepper Hamilton LLP's "Description of the Small Business Investment Company Debenture Program."

For additional information contact:

Christopher A. Rossi | 610.640.7846 | rossic@pepperlaw.com
Michael A. Temple

The material in this publication was created as of the date set forth above and is based on laws, court decisions, administrative rulings and congressional materials that existed at that time, and should not be construed as legal advice or legal opinions on specific facts. The information in this publication is not intended to create, and the transmission and receipt of it does not constitute, a lawyer-client relationship.