March 17, 2011

The Honorable Patrick J. Tiberi
Chairman
Subcommittee on Select Revenue Measures
United States House of Representatives
Committee on Ways and Means
1101 Longworth House Office Building
Washington, DC 20515

The Honorable Richard E. Neal
Ranking Member
Subcommittee on Select Revenue Measures
United States House of Representatives
Committee on Ways and Means
1101 Longworth House Office Building
Washington, DC 20515

Dear Representatives Tiberi and Neal:

As the trade association representing private equity firms that invest in domestic small businesses, we thank you for holding this subcommittee hearing on "The Tax Burden Placed on Small Businesses and Pass-Through Entities." Pass-through entities, such as general, limited, and limited liability partnerships, have always been critical to the formation of capital that investment funds use to make investments in our nation's job-creating small businesses. As tax reform is being contemplated, we would strongly encourage you to consider impacts on small business investing. Small business investors are themselves small businesses structured as pass-through entities.

Pass-through entities were originally created to provide investors with the ability to avoid double taxation on their investments. Pass-through structures allow capital to be pooled with positive returns being taxed only once at the rate of the original business owner, investor, or investment fund. Pass-through entities are not a way for investors to avoid paying taxes; rather, they protect capital providers from being unfairly double-taxed. Tax reform that hinders the pooling of capital for investment would greatly diminish small business investing. The giants of American industry started off as small businesses. A properly reformed tax code will ensure that some of our current small businesses will be major employers tomorrow.

There are too many issues dealing with pass-through entities and small business investing to list in one letter, but an initial sampling of issues that do or could affect small business investing is attached below.

Carried Interest and Small Business Investing

A proposal in President Obama's Fiscal Year 2012 Budget would change the tax treatment of carried interest that flows through pass-through entities from being treated as capital gains to being treated as ordinary income. This tax-treatment change would be particularly harmful for small business investing, and its unintended consequences would be far-reaching.

Because smaller funds survive on performance-based compensation, not administrative fees, dramatically raising the tax rate on carried interest will cease to make economic sense. The only way for a small fund to survive will be to become a very large fund that can survive on fees – fees which are completely disconnected from performance. While large funds play an important role in the market, they generally do not invest in small businesses because it is simply impractical for them to do so. It is far easier for a large fund to make ten $200 million investments in larger companies than to make 400 investments of $5 million in smaller businesses. It is for this reason that small investments are nearly impossible for very large funds. Further, small business investments are not quick flip transactions, but longer term investments. Increasing taxes on these pass-through entities that are small business investors will cut off investment in small businesses.

Capital Gains Exclusion on the Sale of Qualifying Small Business Stock

The recent passage of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 provided for a 100 percent exclusion of the gain from the sale of qualifying small business stock that is acquired before January 1, 2012 and held for more than five years. While this provision is likely to stimulate some investment in small businesses, it is unfortunate that small businesses structured as pass-through entities do not qualify. Including Limited Liability Corporations (LLCs) in this capital gains exclusion would increase capital investment to a broader range of small businesses.

Business Development Companies

A business development company (BDC) is a type of closed-end investment company that elects to be regulated under a specialized regime added to the Investment Company Act of 1940 by the Small Business Investment Incentive Act of 1980. BDCs play an important role in the economy by investing in private or thinly-traded public companies in the form of long-term debt or equity capital, thus, BDCs serve as an important source of capital for small and mid-cap, start-up and pre-IPO companies.

Like typical closed-end funds and ordinary mutual funds, BDCs are eligible to elect to be taxed as regulated investment companies (RICs) under subchapter M of the Internal Revenue Code of 1986. A RIC is a type of pass-through entity similar to a partnership. But unlike a partnership, which is not subject to federal income tax, a RIC is generally subject to federal income tax, but is entitled to claim a deduction for dividends paid to its shareholders. To be eligible to elect RIC status, a BDC must satisfy, among other things, certain source-of-income and asset diversification requirements. The source-of-income requirement requires a BDC to earn at least 90% of its gross income for each year from income that constitutes "good RIC income." This means at least 50% of the value of a BDC's total assets must consist of cash, cash equivalents, U.S. government securities, securities of other regulated investment companies, and other acceptable securities that are issued by issuers that represent no more than 5% of its total assets and in respect of which, it holds no more than 10% of the total voting power; and no more than 25% of the value of the BDC's total assets can be invested in the securities of any one issuer. If a BDC fails to comply with these requirements, it would be subject to tax as an ordinary corporation and would not be entitled to a deduction for any dividends paid to stockholders.

A typical closed-end fund or mutual fund invests in public securities generally has no trouble satisfying these requirements. However, because BDCs invest in small private or thinly traded companies, they often encounter problems complying with, or are limited with regard to their investment alternatives in order to comply with, these requirements.

1. Many small businesses today are organized as partnerships or LLCs that are treated as partnership for tax purposes. If a BDC acquires an equity interest in a partnership or LLC, which is exactly the type of investment BDCs were created to make, the income from such investment during the ownership phase likely will not qualify as “good RIC income” for purposes of the source-of-income test. Whether any gain is recognized on the disposition of such an investment is uncertain. In addition, there is a risk that the BDC would be required to look through such investment for purposes of applying the asset diversification tests. Congress should amend or provide rules that make it easier for BDCs to acquire equity interests in partnerships and LLC without jeopardizing their RIC status.

2. Because typical closed-end funds and mutual funds generally acquire securities in publicly traded entities not organized as partnership or LLCs, any such amendments or provisions could be narrowly focused on and limited to BDCs. To comply with the RIC diversification tests, BDCs are currently limited in their ability to hold more than 10% of the voting interests in portfolio companies. While this restriction provides almost no practical limitation for typical closed-end funds or mutual funds that invest in publicly traded securities, BDCs are often the primary outside investor the small private and thinly traded companies in which they are required to invest and are required by statute to offer managerial assistance to such entities. As a result, limiting the voting rights of BDCs unduly limits their ability to participate in the management of portfolio companies consistent with their ownership interests and requires the creation of new classes of stock or securities to comply with these requirements, which adds additional costs and complexity to the investments.

3. Because the investments held by BDCs are private or thinly traded, to provide greater certainty to BDCs in determining their qualification for RIC status Congress should amend the diversification requirements to allow BDCs to use the basis of their investments rather than the values for testing purposes.

4. Finally, BDC efforts to comply with "good RIC income" requirements (mentioned in 1. above), such as creation of blocker subsidiary corporations, run into direct conflict with SBA rules in cases where BDCs also operate Small Business Investment Companies. In this regard, SBA rules prohibit the setting up of blocker subs (considered "passive" investments). If the BDC rules aren't changed to permit direct equity investing in partnerships and LLCs, then tax and SBA rules should be changed to permit BDC-SBICs to invest equity through blocker subs.

We thank you for the opportunity to provide you with recommendations we feel are vital to ensuring the continued ability of pass-through entities to formulate capital to provide to our nation’s job-creating small businesses.

Sincerely,

Brett Palmer

Brett Palmer
President

Submitted on Behalf Of (Attributed To):

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